

SAFEGUARD SCIENTIFICS INC
Form 10-Q
July 26, 2013

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Quarter Ended June 30, 2013

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Transition Period From _____ to _____

Commission File Number 1-5620

Safeguard Scientifics, Inc.

(Exact name of registrant as specified in its charter)

Pennsylvania
(State or other jurisdiction of
incorporation or organization) 23-1609753
(I.R.S. Employer ID No.)

435 Devon Park Drive
Building 800
Wayne, PA 19087
(Address of principal executive offices) (Zip Code)
(610) 293-0600

Registrant's telephone number, including area code

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Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Number of shares outstanding as of July 25, 2013

Common Stock 26,976,963

SAFEGUARD SCIENTIFICS, INC.

QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

PART I
FINANCIAL
INFORMATION

Page

Item 1 Financial
Statements:

Consolidated
Balance Sheets
(unaudited)
June 30, 2013
and December 31,
2012 3

Consolidated
Statements of
Operations
(unaudited)
Three and Six
Months Ended
June 30, 2013 and
2012 4

Consolidated
Statements of
Comprehensive
Loss (unaudited)
Three and Six
Months Ended
June 30, 2013 and
2012 5

Condensed
Consolidated
Statements of
Cash Flows
(unaudited) Six
Months Ended
June 30, 2013 and
2012 6

<u>Consolidated</u> <u>Statement of</u> <u>Changes in</u> <u>Equity</u> <u>(unaudited) Six</u> <u>Months Ended</u> <u>June 30, 2013</u>	7
-----------------------------------------------------------------------------------------------------------------------------------------------------------	---

<u>Notes to</u> <u>Consolidated</u> <u>Financial</u> <u>Statements</u> <u>(unaudited)</u>	8
-------------------------------------------------------------------------------------------------------	---

<u>Item 2</u> <u>Management's</u> <u>Discussion and</u> <u>Analysis of</u> <u>Financial</u> <u>Condition and</u> <u>Results of</u> <u>Operations</u>	20
---------------------------------------------------------------------------------------------------------------------------------------------------------------------------	----

<u>Item 3</u> <u>Quantitative and</u> <u>Qualitative</u> <u>Disclosures</u> <u>About Market</u> <u>Risk</u>	39
----------------------------------------------------------------------------------------------------------------------------	----

<u>Item 4 Controls</u> <u>and Procedures</u>	39
-------------------------------------------------	----

PART II OTHER
INFORMATION

<u>Item 1A Risk</u> <u>Factors</u>	41
---------------------------------------	----

<u>Item 6 Exhibits</u>	42
------------------------	----

<u>Signatures</u>	43
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SAFEGUARD SCIENTIFICS, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	June 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 102,732	\$ 66,029
Cash held in escrow		6,434
Marketable securities	70,231	110,957
Restricted marketable securities	6	10
Prepaid expenses and other current assets	1,334	2,408
Total current assets	174,303	185,838
Property and equipment, net	164	193
Ownership interests in and advances to partner companies and funds (of which \$ 19,363 and \$20,972 are measured at fair value at June 30, 2013 and December 31, 2012, respectively)	143,100	148,639
Loan participations receivable	8,310	7,085
Available-for-sale securities	18	58
Long-term marketable securities	7,146	29,059
Other assets	3,077	3,272
Total Assets	\$ 336,118	\$ 374,144
LIABILITIES AND EQUITY		
Current Liabilities:		
Convertible senior debentures current	\$ 470	\$ 610
Accounts payable	203	610
Accrued compensation and benefits	3,634	4,050
Accrued expenses and other current liabilities	3,631	2,601
Total current liabilities	7,938	7,261
Other long-term liabilities	3,862	3,921
Convertible senior debentures non-current	48,970	48,991
Total Liabilities	60,770	60,173
Commitments and contingencies		
Equity:		
Preferred stock, \$0.10 par value; 1,000 shares authorized		
Common stock, \$0.10 par value; 83,333 shares authorized; 20,977 and 20,968 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively	2,098	2,097
Additional paid-in capital	817,384	815,946
Accumulated deficit	(544,134)	(504,072)
Total Equity	275,348	313,971
Total Liabilities and Equity	\$ 336,118	\$ 374,144

See Notes to Consolidated Financial Statements.

SAFEGUARD SCIENTIFICS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited In thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
General and administrative expense	\$ 6,715	\$ 5,148	\$ 12,089	\$ 9,891
Operating loss	(6,715)	(5,148)	(12,089)	(9,891)
Other income (loss), net	(2,724)	4,819	(1,967)	7,903
Interest income	790	595	1,524	1,494
Interest expense	(1,074)	(1,456)	(2,143)	(2,908)
Equity loss	(18,400)	(8,947)	(25,387)	(16,395)
Net loss before income taxes	(28,123)	(10,137)	(40,062)	(19,797)
Income tax benefit (expense)				
Net loss	\$ (28,123)	\$ (10,137)	\$ (40,062)	\$ (19,797)
Net loss per share:				
Basic	\$ (1.33)	\$ (0.48)	\$ (1.90)	\$ (0.95)
Diluted	\$ (1.33)	\$ (0.48)	\$ (1.90)	\$ (0.95)
Weighted average shares used in computing basic and diluted loss per share:	21,128	20,927	21,119	20,903

See Notes to Consolidated Financial Statements.

SAFEGUARD SCIENTIFICS, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS

(Unaudited In thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net loss	\$ (28,123)	\$ (10,137)	\$ (40,062)	\$ (19,797)
Other comprehensive income (loss), before taxes:				
Unrealized net gain (loss) on available-for-sale securities	(26)	734	(40)	5,800
Reclassification adjustment for other than temporary impairment of available-for-sale securities included in net loss	26	144	40	144
Total comprehensive loss	\$ (28,123)	\$ (9,259)	\$ (40,062)	\$ (13,853)

See Notes to Consolidated Financial Statements.

SAFEGUARD SCIENTIFICS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited In thousands)

	Six Months Ended June 30,	
	2013	2012
Cash Flows from Operating Activities:		
Net cash used in operating activities	\$ (11,540)	\$ (9,624)
Cash Flows from Investing Activities:		
Proceeds from sales of and distributions from companies and funds	1,403	11,061
Advances and loans to companies	(8,100)	(5,141)
Origination fees on mezzanine loans	42	46
Acquisitions of ownership interests in companies and funds	(15,131)	(16,190)
Increase in marketable securities	(29,913)	(141,997)
Decrease in marketable securities	92,552	133,751
Repayment of advances and loans to companies	928	3,144
Capital expenditures	(21)	(25)
Proceeds from sale of discontinued operations, net	6,434	
Net cash provided by (used in) investing activities	48,194	(15,351)
Cash Flows from Financing Activities:		
Repurchase of convertible senior debentures	(43)	
Issuance of Company common stock, net	92	513
Net cash provided by financing activities	49	513
Net Increase (Decrease) in Cash and Cash Equivalents	36,703	(24,462)
Cash and Cash Equivalents at beginning of period	66,029	83,187
Cash and Cash Equivalents at end of period	\$ 102,732	\$ 58,725

See Notes to Consolidated Financial Statements.

SAFEGUARD SCIENTIFICS, INC.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

(Unaudited In thousands)

		Total		Common Stock		Additional
		Equity	Accumulated	Shares	Amount	Paid-in
			Deficit			Capital
Balance	December 31, 2012	\$ 313,971	\$ (504,072)	20,968	\$ 2,097	\$ 815,946
Net loss		(40,062)	(40,062)			
Stock options exercised, net		92		9	1	91
Issuance of restricted stock, net		49				49
Stock-based compensation expense		1,298				1,298
Balance	June 30, 2013	\$ 275,348	\$ (544,134)	20,977	\$ 2,098	\$ 817,384

See Notes to Consolidated Financial Statements.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. General

The accompanying unaudited interim Consolidated Financial Statements of Safeguard Scientifics, Inc. (Safeguard or the Company) were prepared in accordance with accounting principles generally accepted in the United States of America and the interim financial statement rules and regulations of the SEC. In the opinion of management, these statements include all adjustments (consisting only of normal recurring adjustments) necessary for a fair presentation of the Consolidated Financial Statements. The interim operating results are not necessarily indicative of the results for a full year or for any interim period. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations relating to interim financial statements. The Consolidated Financial Statements included in this Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this Form 10-Q and with the Company's Consolidated Financial Statements and Notes thereto included in the Company's 2012 Annual Report on Form 10-K.

2. Ownership Interests in and Advances to Partner Companies and Funds

The following summarizes the carrying value of the Company's ownership interests in and advances to partner companies and private equity funds.

	June 30, 2013	December 31, 2012
	(In thousands)	
	(Unaudited)	
Fair value	\$ 19,363	\$ 20,972
Equity Method:		
Partner companies	98,997	102,931
Private equity funds	3,714	3,810
	102,711	106,741
Cost Method:		
Partner companies	13,030	10,000
Private equity funds	2,484	2,634
	15,514	12,634
Advances to partner companies	5,512	8,292
	\$ 143,100	\$ 148,639
Loan participations receivable	\$ 8,310	\$ 7,085

Available-for-sale securities \$ 18 \$ 58

The Company recognized impairment charges of \$9.9 million and \$3.7 million related to PixelOptics Inc. (PixelOptics) in the three months ended June 30, 2013 and 2012, respectively, which are reflected in Equity loss in the Consolidated Statements of Operations. The impairment in 2013 was based on the decision of PixelOptics to seek additional capital from independent sources as well as the Company's decision to deploy no substantial additional capital in PixelOptics. The impairment in 2012 was based upon launch delays and related supply chain issues, as well as the pricing of a transaction between other institutional shareholders in PixelOptics.

The Company recorded impairment charges of \$0.3 million and \$0.7 million related to its Penn Mezzanine debt and equity participations in the three months ended June 30, 2013 and 2012, respectively, which are reflected in Other income (loss), net in the Consolidated Statements of Operations. In the three months ended June 30, 2013, the charge included \$0.2 million related to loan participations and \$0.1 million representing an adjustment to the fair value of the Company's participation in warrants. In the three months ended June 30, 2012, the charge included \$0.2 million related to loan participations, \$0.4 million related to equity participations and \$0.1 million representing an adjustment to the fair value of the Company's participation in warrants.

The Company recognized impairment charges of \$0.2 million and \$0.4 million related to its interest in a legacy private equity fund in the first quarter of 2013 and 2012, respectively, which are reflected in Other income (loss), net in the Consolidated Statements of Operations.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

For the three and six months ended June 30, 2013, the Company recognized an unrealized loss of \$2.4 million and \$1.6 million, respectively, on the mark-to-market of its holdings in NuPathe, Inc. (NuPathe), which is included in Other income (loss), net in the Consolidated Statements of Operations.

The following unaudited summarized results of operations for the three months ended March 31, 2013 and 2012 for PixelOptics have been compiled from the unaudited financial statements of PixelOptics.

The results of PixelOptics are reported on a one quarter lag.

	Three Months Ended March 31,	
	2013	2012
	(In thousands)	
	(Unaudited)	
Results of Operations:		
Revenue	\$ 539	\$ 307
Operating loss	\$ (5,855)	\$ (8,721)
Net loss	\$ (7,061)	\$ (9,012)

3. Acquisitions of Ownership Interests in Partner Companies and Funds

During the six months ended June 30, 2013, the Company funded \$2.3 million for participations in loan and equity interests initiated by Penn Mezzanine. Included in this funding were \$2.2 million for participation in a loan and \$0.1 million for participation in equity of the borrower acquired by Penn Mezzanine.

During the six months ended June 30, 2013, the Company funded an aggregate of \$5.3 million of a convertible bridge loan to PixelOptics. The Company previously deployed an aggregate of \$31.6 million in PixelOptics. PixelOptics provides electronic corrective eyeglasses designed to substantially reduce or eliminate the visual distortion and other limitations associated with multifocal lenses. The Company accounts for its interest in PixelOptics under the equity method.

In June 2013, the Company deployed an additional \$5.3 million into Medivo, Inc. (Medivo). The Company had previously acquired an interest in Medivo in November 2011 for \$6.3 million. Medivo is a healthcare IT company that connects patients to a nationwide network of physicians, lab service centers and home testing services. The Company accounts for its interest in Medivo under the equity method. With respect to the June 2013 deployment, the difference

between the Company's cost and its interest in the underlying net assets of Medivo was preliminarily allocated to intangible assets and goodwill as reflected in the carrying value in Ownership interests in and advances to partner companies and funds on the Consolidated Balance Sheets.

In June 2013, the Company funded \$0.3 million of a convertible bridge loan to Alverix, Inc (Alverix). The Company had previously deployed an aggregate of \$8.8 million in Alverix. Alverix provides next-generation instrument and connectivity platforms for diagnostic Point-of-Care testing. The Company accounts for its interest in Alverix under the equity method.

In May 2013, the Company funded \$0.2 million of a convertible bridge loan to Hoopla Software, Inc. (Hoopla). The Company had previously acquired an interest in Hoopla in December 2011 for \$1.3 million. Hoopla helps organizations create high performance sales cultures through software-as-a-service solutions that integrate with customer relationship management systems. The Company accounts for its interest in Hoopla under the equity method.

In March 2013, the Company deployed an additional \$1.7 million into Lumesis, Inc. (Lumesis). The Company had previously acquired an interest in Lumesis in February 2012 for \$2.2 million. Lumesis is a financial technology company that is dedicated to delivering timely data and robust analytical tools for the fixed income marketplace. The Company accounts for its interest in Lumesis under the equity method. The difference between the Company's cost and its interest in the underlying net assets of Lumesis was allocated to intangible assets and goodwill as reflected in the carrying value in Ownership interests in and advances to partner companies and funds on the Consolidated Balance Sheets.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In February 2013, the Company acquired a 6.5% ownership interest in Clutch Holdings, LLC (Clutch) for \$0.5 million. Clutch is a mobile commerce platform that unifies applications associated with gifting, loyalty and shopping programs to improve the customer experience. The Company accounts for its interest in Clutch under the cost method.

In February 2013, the Company acquired a 27.6% ownership interest in Pneuron, Inc. (Pneuron) for \$5.0 million. Pneuron helps enterprise companies reduce the time and cost of application development by building solutions across heterogeneous databases and applications. The Company accounts for its ownership interest in Pneuron under the equity method. The difference between the Company's cost and its interest in the underlying net assets of Pneuron was preliminarily allocated to intangible assets and goodwill as reflected in the carrying value in Ownership interests in and advances to partner companies and funds on the Consolidated Balance Sheets.

In January 2013, the Company acquired a 7.7% interest in Sotera Wireless, Inc. (Sotera). The Company deployed \$1.3 million into Sotera and acquired additional shares from a previous investor for \$1.2 million. Sotera is a medical device company that has developed a wireless patient monitoring platform that is designed to keep clinicians connected to their patients. The Company accounts for its interest in Sotera under the cost method.

4. Fair Value Measurements

The Company categorizes its financial instruments into a three-level fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The fair value hierarchy gives the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). If the inputs used to measure fair value fall within different levels of the hierarchy, the category level is based on the lowest priority level input that is significant to the fair value measurement of the instrument. Financial assets recorded at fair value on the Company's Consolidated Balance Sheets are categorized as follows:

Level 1 Observable inputs that reflect quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 Include other inputs that are directly or indirectly observable in the marketplace.

Level 3 Unobservable inputs which are supported by little or no market activity.

The fair value hierarchy also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The following table provides the carrying value and fair value of certain financial assets and liabilities of the Company measured at fair value on a recurring basis as of June 30, 2013 and December 31, 2012:

Carrying Value	Fair Value Measurement at June 30, 2013		
	Level 1	Level 2	Level 3

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		(In thousands)		
		(Unaudited)		
Cash and cash equivalents	\$ 102,732	\$ 102,732	\$	\$
Cash held in escrow				
Restricted marketable securities	6	6		
Ownership interest in common stock of NuPathe	15,791	15,791		
Ownership interest in warrants and options of NuPathe	3,572			3,572
Available-for-sale securities	18	18		
Warrant participations	417			417
Marketable securities held-to-maturity:				
Commercial paper	\$ 19,237	\$ 19,237	\$	\$
U.S. Treasury Bills	18,180	18,180		
Government agency bonds	22,166	22,166		
Certificates of deposit	17,794	17,794		
Total marketable securities	\$ 77,377	\$ 77,377	\$	\$

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Carrying Value	Fair Value Measurement at December 31, 2012		
		Level 1	Level 2	Level 3
		(In thousands) (Unaudited)		
Cash and cash equivalents	\$ 66,029	\$ 66,029	\$	\$
Cash held in escrow	6,434	6,434		
Restricted marketable securities	10	10		
Ownership interest in common stock of NuPathe	8,897	8,897		
Ownership interest in preferred stock, warrants and options of NuPathe	12,075			12,075
Available-for-sale securities	58	58		
Warrant participations	423			423
Marketable securities held-to-maturity:				
Commercial paper	\$ 50,932	\$ 50,932	\$	\$
U.S. Treasury Bills	21,352	21,352		
Government agency bonds	45,909	45,909		
Certificates of deposit	21,823	21,823		
Total marketable securities	\$ 140,016	\$ 140,016	\$	\$

As of June 30, 2013, \$70.2 million of marketable securities had contractual maturities which were less than one year and \$7.2 million of marketable securities had contractual maturities greater than one year. Held-to-maturity securities are carried at amortized cost, which, due to the short-term maturity of these instruments, approximates fair value using quoted prices in active markets for identical assets or liabilities defined as Level 1 inputs under the fair value hierarchy.

The Company recorded an impairment charge of \$9.9 million related to PixelOptics in the three months ended June 30, 2013 measured as the amount by which PixelOptics carrying value exceeded its estimated fair value. The fair market value of the Company's equity ownership in PixelOptics was determined to be \$3.3 million based on Level 3 inputs as defined above. The inputs and valuation techniques used included primarily an evaluation of discounted cash flows for PixelOptics.

The Company's Penn Mezzanine warrant participations are carried at fair value. The value of the Company's holdings in warrant participations is measured by reference to Level 3 inputs. The inputs and valuation techniques used include discounted cash flows and valuation of comparable public companies. The Company recorded an impairment charge of \$0.3 million related to its Penn Mezzanine debt and equity participations in the three months ended June 30, 2013 measured as the amount by which the carrying value of the Company's participation in the debt, equity and warrant interests acquired by Penn Mezzanine exceeded their estimated fair values.

The Company's ownership interests in NuPathe are accounted for at fair value. In February 2013, the Company converted its 2,500 shares of preferred stock units, acquired in October 2012, into 2.5 million shares of common stock

in NuPathe. The preferred stock units had been valued using Level 3 inputs. The fair value of the Company's ownership interest in NuPathe's common stock was measured using quoted market prices for NuPathe's common stock as traded on the NASDAQ Capital Market, which is considered a Level 1 input under the valuation hierarchy. The fair value of the Company's ownership interest in NuPathe's warrants and options was measured using a Black-Scholes option pricing model, which is based on Level 3 inputs as defined above.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

5. Convertible Debentures and Credit Arrangements

The carrying values of the Company's convertible senior debentures were as follows:

	June 30, 2013	December 31, 2012
		(In thousands) (Unaudited)
Convertible senior debentures due 2018	\$ 48,970	\$ 48,483
Convertible senior debentures due 2014	29	67
Convertible senior debentures due 2024	441	441
	49,440	48,991
Less: current portion	(470)	
Convertible senior debentures - non current	\$ 48,970	\$ 48,991

Convertible Senior Debentures due 2018

In November 2012, Safeguard issued \$55.0 million principal amount of its 5.25% convertible senior debentures due 2018 (the 2018 Debentures). Proceeds from the offering were used to repurchase substantially all of the Company's then outstanding 10.125% convertible senior debentures due 2014 (the 2014 Debentures). Interest on the 2018 Debentures is payable semi-annually on May 15 and November 15.

Holders of the 2018 Debentures may convert their notes prior to November 15, 2017 at their option only under the following circumstances:

during any calendar quarter commencing after the calendar quarter ending on December 31, 2012, if the last reported sale price of the common stock for at least 20 trading days during the period of 30 consecutive trading days ending on the last trading day of the immediately preceding calendar quarter is greater than or equal to 130% of the conversion price on each applicable trading day;

during the five business day period after any five consecutive trading day period in which the trading price per \$1,000 principal amount of notes for each trading day of the measurement period was less than 98% of the product of the last reported sale price of our common stock and the conversion rate on such trading day;

if the notes have been called for redemption; or

upon the occurrence of specified corporate events.

On or after November 15, 2017, until the close of business on the second business day immediately preceding the maturity date, holders may convert their notes at any time, regardless of whether any of the foregoing conditions has been met. Upon conversion, the Company will satisfy its conversion obligation by paying or delivering, as the case may be, cash, shares of common stock or a combination of cash and shares of our common stock, at the Company's election.

The conversion rate of the 2018 Debentures is 55.17 shares of common stock per \$1,000 principal amount of debentures, equivalent to a conversion price of approximately \$18.13 per share of common stock. The closing price per share of the Company's common stock at June 30, 2013 was \$16.05.

On or after November 15, 2016, the Company may redeem for cash any of the 2018 Debentures if the last reported sale price of the Company's common stock exceeds 140% of the conversion price for at least 20 trading days during the period of 30 consecutive trading days ending on the trading day before the date that notice of redemption is given, including the last trading day of such period. Upon any redemption of the 2018 Debentures, the Company will pay a redemption price of 100% of their principal amount, plus accrued and unpaid interest to, but excluding, the date of redemption, and additional interest, if any.

The 2018 Debenture holders have the right to require the Company to repurchase the 2018 Debentures if the Company undergoes a fundamental change, which includes the sale of all or substantially all of the Company's common stock or assets; liquidation; dissolution; a greater than 50% change in control; the delisting of the Company's common stock from the New York Stock Exchange or the NASDAQ Global Market (or any of their respective successors); or a substantial change in the composition of the Company's board of directors as defined in the governing agreement. Holders may require that the Company repurchase for cash

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

all or part of their 2018 Debentures at a fundamental change repurchase price equal to 100% of the principal amount of the debentures to be repurchased, plus accrued and unpaid interest to, but excluding, the fundamental change repurchase date.

Because the 2018 Debentures may be settled in cash or partially in cash upon conversion, the Company separately accounts for the liability and equity components of the 2018 Debentures. The carrying amount of the liability component was determined at the transaction date by measuring the fair value of a similar liability that does not have an associated equity component. The carrying amount of the equity component represented by the embedded conversion option was determined by deducting the fair value of the liability component from the initial proceeds of the 2018 Debentures as a whole. At June 30, 2013, the fair value of the \$55.0 million outstanding 2018 Debentures was approximately \$60.5 million, based on the midpoint of the bid and ask prices as of such date. At June 30, 2013, the carrying amount of the equity component was \$6.4 million, the principal amount of the liability component was \$55.0 million, the unamortized discount was \$6.0 million and the net carrying value of the liability component was \$49.0 million. The Company is amortizing the excess of the face value of the 2018 Debentures over their carrying value over their term as additional interest expense using the effective interest method and recorded \$0.5 million for the six months ended June 30, 2013. The effective interest rate on the 2018 Debentures is 8.7%.

Convertible Senior Debentures due 2024

In 2004, the Company issued an aggregate of \$150.0 million in face value of convertible senior debentures with a stated maturity date of March 15, 2024 (the 2024 Debentures). At June 30, 2013, the fair value of the \$0.4 million outstanding 2024 Debentures approximated their carrying value, based on the midpoint of bid and ask prices as of such date. Interest on the 2024 Debentures is payable semi-annually. At the debenture holders' option, the 2024 Debentures are convertible into the Company's common stock through March 14, 2024, subject to certain conditions. The adjusted conversion rate of the 2024 Debentures is \$43.3044 of principal amount per share. The remaining 2024 Debenture holders have the right to require the Company to repurchase the 2024 Debentures on March 20, 2014 or March 20, 2019 at a repurchase price equal to 100% of their face amount, plus accrued and unpaid interest. In limited circumstances, the Company has the right to redeem all or some of the 2024 Debentures.

Convertible Senior Debentures due 2014

In March 2010, the Company issued an aggregate of \$46.9 million of the 2014 Debentures. As noted above, in November 2012, the Company repurchased substantially all of the 2014 Debentures for \$58.7 million plus accrued interest.

Credit Arrangements

The Company is party to a loan agreement with a commercial bank which provides it with a revolving credit facility in the maximum aggregate amount of \$50 million in the form of borrowings, guarantees and issuances of letters of credit (subject to a \$20 million sublimit). Actual availability under the credit facility is based on the amount of cash maintained at the bank as well as the value of the Company's public and private partner company interests. This credit facility bears interest at the prime rate for outstanding borrowings, subject to an increase in certain circumstances. Other than for limited exceptions, the Company is required to maintain all of its depository and operating accounts and the lesser of \$80 million or 75% of its investment and securities accounts at the bank. The credit facility, as amended December 21, 2012, matures on December 31, 2014. Under the credit facility, the Company provided a \$6.3

million letter of credit expiring on March 19, 2019 to the landlord of CompuCom Systems, Inc.'s Dallas headquarters which was required in connection with the sale of CompuCom Systems in 2004. Availability under the Company's revolving credit facility at June 30, 2013 was \$43.7 million.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

6. Stock-Based Compensation

Stock-based compensation expense was recognized in the Consolidated Statements of Operations as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(In thousands)		(In thousands)	
	(Unaudited)		(Unaudited)	
General and administrative expense	\$ 922	\$ 846	\$ 1,298	\$ 1,229
	\$ 922	\$ 846	\$ 1,298	\$ 1,229

The fair value of the Company's stock-based awards to employees was estimated at the date of grant using the Black-Scholes option-pricing model. The risk-free rate was based on the U.S. Treasury yield curve in effect at the end of the quarter in which the grant occurred. The expected term of stock options granted was estimated using the historical exercise behavior of employees. Expected volatility was based on historical volatility measured using weekly price observations of the Company's common stock for a period equal to the stock option's expected term.

At June 30, 2013, the Company had outstanding options that vest based on three different types of vesting schedules:

1) market based;

2) performance-based; and

3) service-based.

Market-based awards entitle participants to vest in a number of options determined by achievement by the Company of certain target market capitalization increases (measured by reference to stock price increases on a specified number of outstanding shares) over an eight-year period. The requisite service periods for the market-based awards are based on the Company's estimate of the dates on which the market conditions will be met as determined using a Monte Carlo simulation model. Compensation expense is recognized over the requisite service periods using the straight-line method but is accelerated if market capitalization targets are achieved earlier than estimated. During the six months ended June 30, 2013 and 2012, respectively, the Company did not issue any market-based option awards to employees. During the six months ended June 30, 2013 and 2012, respectively, no options vested based on achievement of market capitalization targets. The Company recorded compensation expense related to market-based option awards of \$0.1 million in both the three months ended June 30, 2013 and 2012, and \$0.1 million and \$0.2 million for the six months ended June 30, 2013 and 2012, respectively. Depending on the Company's stock performance, the maximum number of unvested shares at June 30, 2013 attainable under these grants was 956 thousand shares.

Performance-based awards entitle participants to vest in a number of awards determined by achievement by the Company of target capital returns based on net cash proceeds received by the Company on the sale, merger or other

exit transaction of certain identified partner companies. Vesting may occur, if at all, once per year. The requisite service periods for the performance-based awards are based on the Company's estimate of when the performance conditions will be met. Compensation expense is recognized for performance-based awards for which the performance condition is considered probable of achievement. Compensation expense is recognized over the requisite service periods using the straight-line method but is accelerated if capital return targets are achieved earlier than estimated. During the six months ended June 30, 2013 and 2012, respectively, the Company did not issue any performance-based awards to employees. During the six months ended June 30, 2013 and 2012, respectively, no performance-based awards vested. The Company recorded compensation expense related to performance-based option awards of \$0.1 million for both the three months ended June 30, 2013 and 2012, and \$0.2 million and \$0.1 million for the six months ended June 30, 2013 and 2012, respectively. The maximum number of unvested shares at June 30, 2013 attainable under these option grants was 805 thousand shares.

All other outstanding options are service-based awards that generally vest over four years after the date of grant and expire eight years after the date of grant. Compensation expense is recognized over the requisite service period using the straight-line method. The requisite service period for service-based awards is the period over which the award vests. During the six months ended June 30, 2013 and 2012, respectively, the Company issued 28 thousand and 43 thousand service-based option awards to employees. The Company recorded compensation expense related to service-based option awards of \$0.1 million and \$0.3 million for the three months ended June 30, 2013 and 2012, and \$0.2 million and \$0.4 million for the six months ended June 30, 2013 and 2012, respectively.

During the six months ended June 30, 2013 and 2012, respectively, the Company issued 44 thousand and 22 thousand deferred stock units to non-employee directors for annual service grants or fees earned during the preceding quarter. Deferred stock units issued

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

to directors in lieu of directors fees are 100% vested at the grant date; matching deferred stock units equal to 25% of directors fees deferred vest one year following the grant date or, if earlier, upon reaching age 65. Deferred stock units are payable in stock on a one-for-one basis. Payments related to the deferred stock units are generally distributable following termination of employment or service, death or permanent disability.

Total compensation expense for deferred stock units, performance-based stock units and restricted stock was approximately \$0.6 million and \$0.3 million for the three months ended June 30, 2013 and 2012, and \$0.7 million and \$0.5 million for the six months ended June 30, 2013 and 2012, respectively. During the six months ended June 30, 2012, the Company issued five thousand unrestricted shares to members of its advisory board, and recorded expense of \$0.1 million related to these awards.

7. Income Taxes

The Company's consolidated income tax benefit (expense) was \$0.0 million for the three and six months ended June 30, 2013 and 2012. The Company has recorded a valuation allowance to reduce its net deferred tax asset to an amount that is more likely than not to be realized in future years. Accordingly, the tax benefit related to the net operating losses that would have been recognized in the three and six three months ended June 30, 2013 and 2012 were offset by changes in the valuation allowance.

During the three and six months ended June 30, 2013, the Company had no material changes in uncertain tax positions.

8. Net Loss Per Share

The calculations of net loss per share were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
	(In thousands except per share data)			
	(Unaudited)			
Basic:				
Net loss	\$ (28,123)	\$ (10,137)	\$ (40,062)	\$ (19,797)
Weighted average common shares outstanding	21,128	20,927	21,119	20,903
Net loss per share	\$ (1.33)	\$ (0.48)	\$ (1.90)	\$ (0.95)
Diluted:				
Net loss	\$ (28,123)	\$ (10,137)	\$ (40,062)	\$ (19,797)

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Weighted average common shares outstanding	21,128	20,927	21,119	20,903
Net loss per share	\$ (1.33)	\$ (0.48)	\$ (1.90)	\$ (0.95)

Basic and diluted average common shares outstanding for purposes of computing net loss per share includes outstanding common shares and vested deferred stock units (DSUs).

If a consolidated or equity method partner company has dilutive stock options, unvested restricted stock, DSUs or warrants, diluted net loss per share is computed by first deducting the income attributable to the potential exercise of the dilutive securities of the partner company from net loss. Any impact is shown as an adjustment to net loss for purposes of calculating diluted net loss per share.

The following potential shares of common stock and their effects on loss were excluded from the diluted net loss per share calculation because their effect would be anti-dilutive:

- For the three and six months ended June 30, 2013 and 2012, options to purchase 3.3 million and 3.2 million shares of common stock, respectively, at prices ranging from \$3.93 to \$18.80 for both periods, were excluded from the calculations.
- For the three and six months ended June 30, 2013 and 2012, unvested restricted stock units, performance stock units and DSUs convertible into 0.4 million and 0.2 million shares of stock, respectively, were excluded from the calculations.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

- For the three and six months ended June 30, 2013 and 2012, 10 thousand shares of common stock representing the effect of the assumed conversion of the 2024 Debentures, were excluded from the calculations.
- For the three and six months ended June 30, 2013 and 2012, 4 thousand and 2.8 million shares of common stock, respectively, representing the effect of the assumed conversion of the 2014 Debentures, were excluded from the calculations.
- For the three and six months ended June 30, 2013, 3.0 million shares of common stock representing the effect of the assumed conversion of the 2018 Debentures, were excluded from the calculation.

9. Operating Segments

In the fourth quarter of 2012, the Company expanded its focus within the former Life Sciences segment to include companies in the HealthTech sector and renamed that segment Healthcare. The HealthTech sector had previously been included in the Company's Technology segment. AdvantEdge Healthcare Solutions, a provider of physician billing and practice management services and software, which had previously been reported within the Technology segment, is now reported under the Healthcare segment. As a result of the change, the Company has restated its previously reported segment disclosure information, to include the results of AdvantEdge Healthcare Solutions within the Healthcare segment.

As of June 30, 2013, the Company held interests in 20 non-consolidated partner companies which are included in the Healthcare and Technology segments. Included in the Penn Mezzanine segment are the Company's interests in the Penn Mezzanine management company and general partner and the Company's participations in mezzanine loans and equity interests initiated by Penn Mezzanine.

The Company's active partner companies by segment were as follows as of June 30, 2013:

Healthcare	Safeguard Primary Ownership	
Partner Company	as of June 30, 2013	Accounting Method
AdvantEdge Healthcare Solutions, Inc.	40.2%	Equity
Alverix, Inc.	49.2%	Equity

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Crescendo Bioscience, Inc.	12.6%	Cost
Good Start Genetics, Inc.	30.0%	Equity
Medivo, Inc.	34.5%	Equity
NovaSom, Inc.	30.3%	Equity
NuPathe, Inc.	16.6%	Fair value (1)
PixelOptics, Inc.	24.6%	Equity
Putney, Inc.	27.6%	Equity
Sotera Wireless, Inc.	7.4%	Cost

Technology

Partner Company	Safeguard Primary Ownership as of June 30, 2013	Accounting Method
AppFirst, Inc.	35.0%	Equity
Beyond.com, Inc.	38.3%	Equity
Bridgevine, Inc.	22.5%	Equity
DriveFactor, Inc.	35.4%	Equity
Hoopla Software, Inc.	25.3%	Equity
Lumesis, Inc.	44.2%	Equity
MediaMath, Inc.	22.2%	Equity
Pneuron, Inc.	27.6%	Equity
Spongecell, Inc.	23.1%	Equity
ThingWorx, Inc.	39.8%	Equity

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(1) The Company's ownership interest in NuPathe was accounted for as available-for-sale securities following NuPathe's completion of an initial public offering in August 2010. In October 2012, the Company participated in a private placement of NuPathe preferred stock units, and in conjunction with this financing, the Company placed two persons on NuPathe's board of directors. As a result, the Company determined that it exercised significant influence over NuPathe which made the equity method of accounting applicable to its ownership interests. Instead, the Company elected the fair value option beginning in October 2012. Prior to August 2010, the Company accounted for NuPathe under the equity method.

As of June 30, 2013, in the Penn Mezzanine segment, the Company has a 36% ownership interest in the management company and general partner of Penn Mezzanine L.P. The Company accounts for its interest under the equity method.

Results of the Healthcare and Technology segments reflect the equity income (loss) of their respective equity method partner companies, other income (loss) associated with fair value method and cost method partner companies and the gains or losses on the sale of their respective partner companies. Results of the Penn Mezzanine segment includes interest, dividends and participation fees earned on the mezzanine interests in which the Company participates as well as equity income (loss) associated with the Company's management company and general partner interest in the Penn Mezzanine platform.

Management evaluates the Healthcare and Technology segments' performance based on net income (loss) which is based on the number of partner companies accounted for under the equity method, the Company's voting ownership percentage in these partner companies and the net results of operations of these partner companies, any impairment charges or gain (loss) on the sale of equity and cost method partner companies.

Management evaluates the Penn Mezzanine segment performance based on the performance of the mezzanine interests in which the Company participates. This includes an evaluation of the current and future cash flows associated with interest and dividend payments as well as estimated losses based on evaluating known and inherent risks in the investments in which the Company participates.

Other Items include certain expenses which are not identifiable to the operations of the Company's operating business segments. Other Items primarily consist of general and administrative expenses related to corporate operations, including employee compensation, insurance and professional fees, including legal and finance, interest income, interest expense and other income (loss) and equity income (loss) related to certain private equity fund ownership interests. Other Items also include income taxes, which are reviewed by management independent of segment results.

As of June 30, 2013 and December 31, 2012, all of the Company's assets were located in the United States.

SAFEGUARD SCIENTIFICS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Segment assets in Other Items included primarily cash, cash equivalents, cash held in escrow, and marketable securities of \$180.1 million and \$212.5 million, at June 30, 2013 and December 31, 2012, respectively.

	Three Months Ended June 30, 2013						Total	191	5.42%	16,166	768	4.0%
	Healthcare	Technology	Penn Mezzanine	Total Segments	Other Items	Total						
Investment-earning assets	697,936	\$ 45,147	6.47%	683,393	\$ 57,156	8.36%	585,500	\$ 47,356	8.09%			
Provision for doubtful credit assets	(12,269)			(9,787)			(8,067)					
Interest-bearing assets:												
Due and due from banks	20,785			25,255			26,426					
Loans and advances, net	14,981			15,899			12,706					
Unearned interest receivable	2,779			4,061			3,597					
Real estate owned	9,434			3,187			3,354					
Other assets	44,237			42,326			32,570					
Total average interest-earning assets	\$ 777,883			\$ 764,334			\$ 656,086					
Liabilities and shareholders' equity:												
Interest-bearing liabilities:												
Money market accounts	\$ 42,988	\$ 223	0.52%	\$ 46,382	\$ 292	0.63%	\$ 49,118	\$ 286	0.58%			
Time deposits	124,202	2,963	2.39%	136,720	4,246	3.11%	138,242	3,701	2.68%			
Other deposits	40,699	482	1.18%	46,225	883	1.91%	35,135	198	0.56%			
Other borrowings	230,746	8,420	3.65%	263,196	12,993	4.94%	195,922	8,412	4.29%			
Preferred stock	91,368	2,116	2.32%	17,891	925	5.17%	4,209	223	5.30%			
Other liabilities	12,710	734	5.77%	15,537	1,234	7.94%	15,464	1,355	8.76%			
Total interest-bearing liabilities	542,713	\$ 14,938	2.75%	525,951	\$ 20,573	3.91%	438,090	\$ 14,175	3.24%			

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interest-bearing				
king	144,772	146,954	146,722	
ued interest				
ble	1,131	2,207	2,021	
r liabilities	6,782	7,221	5,615	
verage				
ities	695,398	682,333	592,448	
verage				
holders' equity	82,485	82,001	63,638	
verage				
ities and				
holders'				
y	\$ 777,883	\$ 764,334	\$ 656,086	
est income as a				
centage				
verage earning				
s		6.47%	8.36%	8.09%
est expense as				
centage				
verage earning				
s		2.14%	3.01%	2.42%
interest margin		4.33%	5.35%	5.67%

- (1) Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan fees of approximately \$3,074,000, \$3,076,000, and \$3,536,000 for the years ended December 31, 2008, 2007, and 2006, respectively.
- (2) Applicable nontaxable securities yields have not been calculated on a tax-equivalent basis because they are not material to the Company's results of operations.

As summarized in Table 2, the increase in net interest income between the two twelve-month periods ended December 31, 2008 and 2007 is comprised of a decrease in total interest income of approximately \$12.0 million, which was only partially offset by a decrease in total interest expense of approximately \$5.6 million. The Bank's net interest margin, as shown in Table 1, decreased to 4.33% at December 31, 2008 from 5.35% at December 31, 2007, a decrease of 102 basis points (100 basis points = 1%) between the two periods. The net margin of 5.35% reported during 2007 represents a decrease of 32 basis points from the 5.67% net margin realized by the Company during 2006. While average assets have grown over the past three years and the balance sheet mix has changed, interest rate movements over those three years have played a significant role in net interest income trends. As a result of changes in market rates of interest, the prime rate averaged 5.09% for the year ended December 31, 2008 as compared to 8.05% and 7.96% for the years ended December 31, 2007 and 2006, respectively.

Both the Company's net interest income and net interest margin are affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities, referred to as "volume change." Both are also affected by changes in yields on interest-earning assets and rates paid on interest-bearing liabilities, referred to as "rate change." The following table sets forth the changes in interest income and interest expense for each major category of interest-earning asset and interest-bearing liability, and the amount of change attributable to volume and rate changes for the years indicated. Changes in interest income and expense, which are not attributable specifically to either rate or volume, are allocated proportionately between the two variances based on the absolute dollar amounts of the change in each.

Table 2. Rate and Volume Analysis

(In thousands)	2008 compared to 2007			2007 compared to 2006		
	Total	Rate	Volume	Total	Rate	Volume
Increase (decrease) in interest income:						
Loans	\$ (13,021)	\$ (13,660)	\$ 639	\$ 9,788	\$ (275)	\$ 10,063
Investment securities	1,234	906	328	642	628	14
Interest-bearing deposits in other banks	(49)	(84)	35	(53)	(25)	(28)
Federal funds sold and securities purchased under agreements to resell	(173)	(36)	(137)	(577)	95	(672)
Total interest income	\$ (12,009)	(12,874)	865	9,800	423	9,377
Increase (decrease) in interest expense:						
Interest-bearing demand accounts	(1,352)	(909)	(443)	551	643	(92)
Savings accounts	(401)	(290)	(111)	685	605	80
Time deposits	(4,573)	(3,598)	(975)	4,581	1,391	3,190
Other borrowings	1,191	(826)	2,017	702	(6)	708

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Trust Preferred securities	(500)	(262)	(238)	(121)	(127)	6
Total interest expense	(5,635)	(5,885)	250	6,398	2,506	3,892
Increase (decrease) in net interest income	\$ (6,374)	\$ (6,989)	\$ 615	\$ 3,402	\$ (2,083)	\$ 5,485

Total interest income decreased approximately \$12.0 million or 21.0% between the years ended December 31, 2007 and 2008, and is attributable primarily to significant declines in market rates of interest resulting in decreased net interest margins, which outweighed minor increases experienced in average earning assets. Loans were most adversely impacted by yield declines as approximately two-thirds of the loan portfolio is comprised of floating rate instruments.

Total interest expense decreased approximately \$5.6 million between the years ended December 31, 2007 and 2008, primarily as a result of decreased rates paid on deposit accounts and other borrowings as market rates of interest continued to decline throughout most of 2008. Rates paid on interest-bearing liabilities decreased in all categories, with the greatest decreases experienced in time deposits, borrowings through the FHLB and the FRB, and the Company's junior subordinated debt. The Company's interest-bearing liability mix changed during 2008 with declines in average deposit accounts, especially time deposits, which was more than offset by increases in the average volume of other borrowings including FHLB advances and overnight borrowings from the Federal Reserve. On average, time deposits decreased \$32.5 million, interest-bearing demand accounts decreased by \$15.9 million, and savings accounts decreased by \$5.5 million between the years ended December 31, 2007 and December 31, 2008. The decrease in average deposits was more than offset by increases of more than \$73.5 million in other borrowings between the years ended December 31, 2007 and December 31, 2008.

Total interest income increased approximately \$9.8 million or 20.7% between the years ended December 31, 2006 and 2007, and was attributable primarily to increase in earning asset volume, as well as the yields on those earning assets to a lesser degree. Earning asset growth was almost exclusively in loans, with minimal growth in investments. On average, loans grew by approximately \$111.0 million between 2006 and 2007. The Company continues to maintain a high percentage of loans in its earning asset mix with loans averaging 85.0% of total earning assets for the year ended December 31, 2007, as compared to 80.3% and 72.5% for the years ended December 31, 2006 and 2005, respectively.

Total interest expense increased approximately \$6.4 million between the years ended December 31, 2006 and 2007, both as a result of increased volumes in time deposits and other borrowings, as well as increased rates paid on deposit accounts as deposit rates continued to rise throughout much of 2007. Deposit rates began to decline during the fourth quarter of 2007 as market rates of interest declined as a result of the Federal Reserve's actions to protect a faltering economy. Between the years ended December 31, 2007 and December 31, 2006, rates paid on interest-bearing liabilities increased in all categories except other borrowing and junior subordinated debt, with the greatest increases experienced in time deposits, money market deposits, and savings accounts. The increases experienced in savings account rates during 2007 were largely the result of more than \$25.0 million in savings accounts purchased with Legacy Bank during February 2007, many of which carried high preferential interest rates. Some of those savings accounts have been closed, and the Company has been able to reduce the cost of the remaining accounts as the preferential rate terms of the savings accounts expired.

Provision for Credit Losses

Provisions for credit losses and the amount added to the allowance for credit losses is determined on the basis of management's continuous credit review of the loan portfolio, consideration of past loan loss experience, current and future economic conditions, and other pertinent factors. Such factors consider the allowance for credit losses to be adequate when it covers estimated losses inherent in the loan portfolio. Based on the condition of the loan portfolio, management believes the allowance is sufficient to cover risk elements in the loan portfolio. For the year ended December 31, 2008 the provision to the allowance for credit losses amounted to \$9.6 million as compared to \$5.7 million and \$880,000 for the years ended December 31, 2007 and 2006, respectively.

Increases in the provision to the allowance for credit losses during 2008, including provisions of \$6.4 million and \$2.4 million in the third and fourth quarters of 2008, respectively, were the result of higher levels of nonperforming loans during the year, and general deterioration in the housing and credit markets which began during the later part of 2007, and continued throughout 2008.

As with 2008, increases in the provision to the allowance for credit losses during 2007 included larger provisions during the third and fourth quarters of the year as the economy and the banking industry began to realize the full impact of the weakened housing and credit markets during the later part of 2007. Provisions of \$2.0 million and \$3.3 million were made in the third and fourth quarters of 2007. The amount provided to the allowance for credit losses during 2008 brought the allowance to 2.75% of net outstanding loan balances at December 31, 2008, as compared to 1.83% of net outstanding loan balances at December 31, 2007, and 1.68% at December 31, 2006.

Noninterest Income

The following table summarizes significant components of noninterest income for the years indicated and the net changes between those years:

(In thousands)	Years Ended December 31,			Increase (decrease) during Year	
	2008	2007	2006	2008	2007
Customer service fees	\$ 4,656	\$ 4,790	\$ 3,779	\$ (134)	\$ 1,011
Gain on disposition of securities	24	0	27	24	(27)
Gain (loss) on sale of OREO	67	209	50	(142)	159
Proceeds from life insurance	0	483	482	(483)	1
Gain (loss) on swap ineffectiveness	9	66	(75)	(57)	141
Gain on fair value option of financial liabilities	1,363	2,504	0	(1,141)	2,504
Gain on sale of investment	0	0	1,877	—	(1,877)
Gain (loss) on sale of fixed assets	(4)	2	1,018	(6)	(1,016)
Shared appreciation income	265	42	567	223	(525)
Other	1,963	1,568	1,306	395	262
Total	\$ 8,343	\$ 9,664	\$ 9,031	\$ (1,321)	\$ 633

Noninterest income consists primarily of fees and commissions earned on services that are provided to the Company's banking customers and, to a lesser extent, gains on sales of Company assets and other miscellaneous income.

Noninterest income for the year ended December 31, 2008 decreased \$1.3 million or 13.7% when compared to the previous year, and decreased \$688,000 or 7.6% when compared to the year ended December 31, 2006. Decreases in noninterest income experienced during 2008 were primarily the result of a decrease SFAS No. 157 fair value gains recorded on the Company's junior subordinated debt, as well as an employee death-benefit payment received during 2007 that did not occur again during 2008. The gain on disposition of securities totaling \$24,000 during 2008 was the result of an early call on municipal bonds with an amortized cost of approximately \$940,000. The municipal bonds were redeemed at face value, resulting in a recognized gain on the remaining unaccrued discount.

Customer service fees continue to provide a substantial part of noninterest income over the three years presented. Customer service fees decreased \$134,000 between the years ended December 2007 and December 31, 2008, which is attributable almost exclusively to decreases in ATM fee income. Increases of \$1.0 million in customer service fees between 2006 and 2007 were comprised of increases in ATM and overdraft charges, as well as additional fee revenue

generated by the Campbell branch acquired during February 2007.

Increases in noninterest income experienced during 2007 were primarily the result of a \$2.5 million gain recognized on the change in fair value to the Company's junior subordinated debt. With the deterioration in credit markets during the second half of 2007, the rate on the Company's junior subordinated debt was far below current market rates of interest on similar instruments, resulting in the significant gains recorded during the third and fourth quarters of 2007. This was offset during 2007 by a decline in gain on sale of investments, and gain on sale of fixed assets. Declines in gain on sale of investments resulted from a \$1.8 million gain on the sale of an investment in correspondent bank during the first quarter of 2006, which was not again experienced during 2007. Declines in gain on sale of fixed assets resulted from a \$1.0 million gain on the sale of the Company's administrative headquarters during the third quarter of 2006, which was not again experienced during 2007. Noninterest income was further enhanced during the years ended December 31, 2007 and December 31, 2006 from death-benefit proceeds realized from the Company's bank owned life insurance totaling \$483,000 and \$482,000 during those two years, respectively.

Shared appreciation income has fluctuated over the three years presented, with increases of \$223,000 between 2007 and 2008, as compared to decreases of \$525,000 between 2006 and 2007. Shared appreciation income results from agreements between the Company and the borrower on certain construction loans where the Company agrees to receive interest on the loan at maturity rather than monthly and the borrower agrees to share in the profits of the project. The profit is determined by the appraised value of the completed project and subsequent refinancing or sale of the project. Due to the difficulty in calculating future values, shared appreciation income is recognized when received. The Company does not participate in a significant number of shared appreciation projects, and as a result, does not anticipate large amounts of shared appreciation income on an ongoing basis.

Noninterest Expense

The following table sets forth the components of total noninterest expense in dollars and as a percentage of average earning assets for the years ended December 31, 2008, 2007 and 2006:

(Dollars in thousands)	2008		2007		2006	
	Amount	% of Average Earning Assets	Amount	% of Average Earning Assets	Amount	% of Average Earning Assets
Salaries and employee benefits	\$ 10,610	1.52%	\$ 10,830	1.58%	\$ 9,915	1.69%
Occupancy expense	3,954	0.57%	3,787	0.55%	2,556	0.44%
Data processing	279	0.04%	420	0.06%	470	0.08%
Professional fees	1,482	0.21%	1,811	0.27%	998	0.17%
Directors fees	262	0.04%	268	0.04%	222	0.04%
Amortization of intangibles	972	0.14%	1,021	0.15%	537	0.09%
Correspondent bank service charges	427	0.06%	476	0.07%	204	0.03%
Impairment loss on other investments	23	0.00%	17	0.00%	0	0.00%
Impairment loss on OREO	887	0.13%	0	0.00%	0	0.00%
Impairment loss on intangible assets	648	0.09%	0	0.00%	0	0.00%
Loss on lease assets held for sale	0	0.00%	820	0.12%	0	0.00%
Loss on CA Tax Credit Partnership	432	0.06%	430	0.06%	440	0.08%
OREO expense	418	0.06%	209	0.03%	2,193	0.37%
Other	2,885	0.41%	2,643	0.39%	2,402	0.41%
Total	\$ 23,279	3.34%	\$ 22,732	3.33%	\$ 19,937	3.41%

Noninterest expense, excluding provision for credit losses and income tax expense, totaled \$23.3 million for the year ended December 31, 2008 as compared to \$22.7 million and \$19.9 million for the years ended December 31, 2007 and 2006, respectively. These figures represent an increase of \$547,000 or 2.4% between the years ended December 31, 2007 and 2008 and an increase of \$2.8 million or 14.0% between the years ended December 31, 2006 and 2007. As a percentage of average earning assets, total noninterest expense has remained relatively stable over the past three years as the Company has successfully controlled overhead expenses while experiencing profitable growth. Noninterest expense amounted to 3.34% of average earning assets for the year ended December 31, 2008 as compared to 3.33% at December 31, 2007 and 3.41% at December 31, 2006.

Increases in noninterest expense between the years ended December 31, 2007 and December 31, 2008 include impairment losses of \$887,000 on OREO, and \$648,000 on intangible assets. With economic conditions deteriorating during 2008, increased emphasis has been placed on impairment review, as the values on many assets have declined. Impairment losses on OREO properties are also a function of an increase in the volume of OREO acquired during 2008, which is also reflected in the increase of \$209,000 in OREO expense during 2008. Decreases in noninterest expense have been realized in many categories during 2008 including a decrease of \$220,000 in salary expense, \$141,000 in data processing expense, and \$329,000 in professional fees. The decrease in salary expense between the years ended December 31, 2007 and December 31, 2008 is primarily the result of a reduction in bonuses and incentives paid during 2008, many of which are based upon the Company's net income.

Increases in noninterest expense during 2007 included costs associated with the new branch operations in Campbell, California, resulting from the merger with Legacy Bank, additional employee costs associated with the new financial services department acquired during November 2007, increased professional fees associated with the resolution of impaired loans, losses on lease assets held for sale, and increased amortization costs for intangible assets. Losses on lease assets held for sale totaled \$820,000 for the year ended December 31, 2007 and are the result of charge-offs of foreclosed lease assets, mainly equipment and furniture, which the Company has determined have no value or cannot be located. Decreases in OREO expense during 2007 were the primarily result of additional disposal and clean-up costs, incurred during 2006 on a single OREO property, which was in the process of liquidation. These additional OREO costs were not incurred again during 2007.

During the years ended December 31, 2008, 2007, and 2006, the Company recognized stock-based compensation expense of \$110,000 (\$0.01 per share basic and diluted), \$187,000 (\$0.02 per share basic and diluted), and \$248,000 (\$0.02 per share basic and diluted), respectively. This expense is included in noninterest expense under salaries and employee benefits. Under the current pool of stock options, the Company expects stock-based compensation expense to be about \$13,000 per quarter during 2009, then to \$6,000 per quarter for 2010, and decline after that through 2011. If new stock options are issued, or existing options fail to vest due, for example, to forfeiture, actual stock-based compensation expense in future periods will change.

Income Taxes

On December 31, 2003 the California Franchise Tax Board (FTB) announced certain tax transactions related to real estate investment trusts (REITs) and regulated investment companies (RICs) will be disallowed pursuant to Senate Bill 614 and Assembly Bill 1601, which were signed into law in the 4th quarter of 2003. As a result, the Company reversed related net state tax benefits recorded in the first three quarters of 2003 and has taken no related tax benefits since that time. The Company continues to review the information available from the FTB and its financial advisors and believes that the Company's position has merit. The Company will pursue its tax claims and defend its use of these entities and transactions. At this time, the Company cannot predict the ultimate outcome.

During the first quarter of 2005, the FTB notified the Company of its intent to audit the REIT for the tax years ended December 2001 and 2002. The Company has retained legal counsel to represent it in the tax audit, and counsel has provided the FTB with documentation supporting the Company's position. The FTB concluded its audit during January 2006. During April 2006, the FTB issued a Notice of Proposed Assessment to the Company, which included proposed tax and penalty assessments related to the tax benefits taken for the REIT during 2002. The Company still believes the case has merit based upon the fact that the FTB is ignoring certain facts of law in the case. The issuance of the Notice of Proposed Assessment by the FTB will not end the administrative processing of the REIT issue because the Company has asserted its administrative protest and appeal rights pending the outcome of litigation by another taxpayer presently in process on the REIT issue in the Los Angeles Superior Court (*City National v. Franchise Tax Board*). The case is ongoing and may take several years to complete.

On January 1, 2007 the Company adopted Financial Accounting Standards Board (FASB) Interpretation 48 (FIN 48), "Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109". FIN 48 clarifies SFAS No. 109, "Accounting for Income Taxes", to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of FIN48, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term "more likely than not" means a likelihood of more than 50 percent." In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority.

The Company has reviewed its REIT tax position as of January 1, 2007 (adoption date), and then again each subsequent quarter thereafter in light of the adoption of FIN48. The Bank, with guidance from advisors believes that the case has merit with regard to points of law, and that the tax law at the time allowed for the deduction of the consent dividend. However, the Bank, with the concurrence of advisors, cannot conclude that it is "more than likely" (as defined in FIN48) that the Bank will prevail in its case with the FTB. As a result of this determination, effective January 1, 2007 the Company recorded an adjustment of \$1.3 million to beginning retained earnings upon adoption of FIN48 to recognize the potential tax liability under the guidelines of the interpretation. The adjustment includes amounts for assessed taxes, penalties, and interest. During the years ended December 31, 2008 and 2007, the Company increased the unrecognized tax liability by an additional \$87,000 in interest for each of the two years, bringing the total recorded tax liability under FIN48 to \$1.5 million and \$1.4 million at December 31, 2008, and December 31, 2007, respectively. It is the Company's policy to recognize interest and penalties under FIN48 as a component of income tax expense. The Company has reviewed all of its tax positions as of December 31, 2008, and has determined that, other than the REIT, there are no other material amounts that should be recorded under the guidelines of FIN48.

Financial Condition

Total assets decreased by \$10.6 million or 1.4% during the year to \$761.1 million at December 31, 2008, but increased \$82.8 million or 12.2% from the balance of \$678.3 million at December 31, 2006. During the year ended December 31, 2008, decreases were experienced in loans as construction and real estate lending slowed and approximately \$23.0 million in problem loans were transferred to OREO. Interest-bearing deposits in other banks and investment securities increased by \$17.5 million and \$3.3 million, respectively, during the year ended December 31, 2008. During 2007, net loans increased \$94.4 million, while federal funds sold decreased \$14.3 million, and investment securities increased \$6.0 million between the two period-ends. The Legacy Bank acquisition completed during February 2007 added \$62.4 million in net loans, \$7.4 in investments, and \$69.6 in deposits to the Company's balance sheet during 2007.

Total deposits of \$508.5 million at December 31, 2008 decreased \$126.1 million or 19.9% from the balance reported at December 31, 2007, and decreased \$78.6 million or 13.4% from the balance of \$587.1 million reported at December 31, 2006. During 2008, growth of \$10.5 million and \$13.4 million was experienced in noninterest-bearing deposits and time deposits of less than \$100,000, respectively, which was more than offset by substantial declines in time deposits of \$100,000 or more, and to a lesser degree interest-bearing checking and savings accounts. The decrease of \$130.9 million in time deposits of \$100,000 or more experienced during 2008 was primarily the result of brokered time deposits and deposits from the State of California, which were not renewed as they matured during 2008. The brokered time deposits were replaced with less expensive borrowings including FHLB advances and overnight borrowings from the Federal Reserve Discount Window.

Earning assets averaged approximately \$697.9 million during the year ended December 31, 2008, as compared to \$683.4 million and \$585.5 million for the years ended December 31, 2007 and 2006, respectively. Average interest-bearing liabilities increased to \$542.7 million for the year ended December 31, 2008, as compared to \$526.0 million for the year ended December 31, 2007, and increased from the balance of \$438.1 million for the year ended December 31, 2006.

Loans

The Company's primary business is that of acquiring deposits and making loans, with the loan portfolio representing the largest and most important component of its earning assets. Loans totaled \$550.0 million at December 31, 2008, representing a decrease of \$48.2 million or 8.1% when compared to the balance of \$598.2 million at December 31, 2007, and an increase of \$49.4 million or 9.9% when compared to the balance of \$500.6 million reported at December 31, 2006. Total loans decreased approximately \$57.1 million during the fourth quarter of 2008, about half of which was the result of transfers of nonperforming loans to OREO. Average loans totaled \$587.9 million, \$580.9 million, and \$470.0 million for the years ended December 31, 2008, 2007 and 2006, respectively. During 2008 average loans increased 1.2% when compared to the year ended December 31, 2007 and increased 25.1% compared to the year ended December 31, 2006.

The following table sets forth the amounts of loans outstanding by category and the category percentages as of the year-end dates indicated:

(In thousands)	2008		2007		2006		2005		2004	
	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans	Dollar Amount	% of Loans
Commercial and industrial	\$ 223,581	40.7%	\$ 204,385	34.2%	\$ 155,811	31.1%	\$ 113,263	27.1%	\$ 123,720	31.0%
Real estate – mortgage	126,689	23.0	142,565	23.8	113,613	22.7	89,503	21.4	88,187	22.1
Real estate – construction	119,885	21.7	178,296	29.8	168,378	33.7	162,873	38.9	137,523	34.5
Agricultural	52,020	9.5	46,055	7.7	35,102	7.0	24,935	6.0	23,416	5.9
Installment/other	20,782	3.8	18,171	3.0	16,712	3.3	15,002	3.6	13,257	3.3
Lease financing	7,020	1.3	8,748	1.5	10,952	2.2	12,334	3.0	12,581	3.2
Total Loans	\$ 549,977	100.0%	\$ 598,220	100.0%	\$ 500,568	100.0%	\$ 417,910	100.0%	\$ 398,684	100.0%

Loan volume continues to be greatest in what has historically been the Bank's primary lending emphasis: commercial, real estate mortgage, and construction lending. With the continued deterioration of real estate markets during 2008, the Company experienced a decrease of \$58.4 million or 32.8 % in construction loans, and a decrease of \$15.9 million in real estate mortgage loans. Lease financing decreased \$1.7 million during 2008, as the Company is no longer

originating commercial leases. Partially offsetting these decreases were increases of \$19.2 million in commercial loans, \$6.0 million in agricultural loans, and \$2.6 million in consumer installment loans. Part of the decrease in construction and real estate loans experienced during 2008 is the result of transfers of approximately \$28.5 million (\$26.0 million net of charge-offs) in nonperforming loans to OREO.

During 2007 loan growth occurred in all categories except lease financing. During 2007, significant increases occurred in commercial and industrial loans, as well as real estate mortgage loans, with increases of \$48.6 million or 31.2% and \$29.0 million or 25.5% in those two categories, respectively. Agricultural loans increased \$11.0 million or 31.2% during 2007, and real estate construction loans increased \$9.9 million or 5.9% during 2007. The acquisition of Legacy Bank during February 2007 contributed approximately \$63.9 million to the loan growth experienced during 2007. During the fourth quarter of 2007 loan volume declined approximately \$27.7 million or 4.4% as the Company slowed additional loan growth as part of its asset/liability management and liquidity plan.

During 2006, loan growth occurred in all categories except lease financing. The most significant loan increases during 2006 occurred in commercial and industrial loans, real estate mortgage loans, and agricultural loans, with increases of \$42.5 million, \$24.1 million, and \$10.2 million experienced in those three categories, respectively. Real estate construction loans increased a modest \$5.5 million or 3.4% during 2006 as the real estate construction market remained stable within the San Joaquin Valley.

At December 31, 2008, approximately 78% of commercial and industrial loans have floating rates and, although some may be secured by real estate, many are secured by accounts receivable, inventory, and other business assets. Residential housing markets have suffered considerably since the later half of 2007, and as a result, residential construction loans decreased during 2008. Real estate construction loans decreased \$58.4 million or 32.8% during 2008, as compared to an increase of \$9.9 million or 5.9 % during 2007, and an increase of \$5.5 million or 3.4% during 2006. Construction loans are generally short-term, floating-rate obligations, which consist of both residential and commercial projects. Agricultural loans consisting of mostly short-term, floating rate loans for crop financing, increased \$6.0 million or 13.0% between December 31, 2007 and December 31, 2008, while installment loans increased \$2.6 million or 14.4% during that same period.

The real estate mortgage loan portfolio totaling \$126.7 million at December 31, 2008 consists of commercial real estate, residential mortgages, and home equity loans. Commercial real estate is the core of this segment of the portfolio, with balances of \$81.8 million, \$102.4 million, and \$71.7 million at December 31, 2008, 2007, and 2006, respectively. Commercial real estate loans are generally a mix of short to medium-term, fixed and floating rate instruments and, are mainly tied to commercial income and multi-family residential properties. The Company does not currently offer traditional residential mortgage loans, but may purchase mortgage portfolios. As a result of real estate mortgage purchases over the past several years, that portion of the portfolio has remained stable with balances of \$41.6 million, \$37.2 million, and \$39.2 million at December 31, 2008, 2007 and 2006, respectively. The Company also offers short to medium-term, fixed-rate, home equity loans, which totaled \$3.2 million at December 31, 2008, \$3.0 million at December 31, 2007, and \$2.7 million at December 31, 2006.

The following table sets forth the maturities of the Bank's loan portfolio at December 31, 2008. Amounts presented are shown by maturity dates rather than repricing periods:

(In thousands)	Due in one year or less	Due after one Year through Five years	Due after Five years	Total
Commercial and agricultural	\$ 174,972	\$ 78,307	\$ 22,321	\$ 275,600
Real estate – construction	116,856	3,028	0	119,884
	291,828	81,335	22,321	395,484
Real estate – mortgage	13,968	59,703	53,018	126,689
All other loans	13,383	11,649	2,771	27,803
Total Loans	\$ 319,179	\$ 152,687	\$ 78,110	\$ 549,976

The average yield on loans was 6.75% for the year ended December 31, 2008, representing a decrease of 232 basis points when compared to the year ended December 31, 2007 and was a result of a significant decrease in market rates of interest during 2008. The average loan yield for 2008 was also impacted by the reversal of approximately \$1.0 million in interest on nonaccrual loans, reducing the average loan yield by 17 basis points for the year ended December 31, 2008. For the year ended December 31, 2007, the average yield on loans was 9.07%, representing a decrease of 6 basis points when compared to the year ended December 31, 2006 and was a result of increased loan pricing pressures experienced during 2007 which more than outweighed an average increase of 9 basis point in the prime rate between the year ended December 31, 2006 and December 31, 2007. The Bank's loan portfolio is generally comprised of short-term or floating rate loans and is therefore susceptible to fluctuations in market rates of interest. At December 31, 2008, 2007 and 2006, approximately 64.0%, 62.3% and 59.5% of the Bank's loan portfolio consisted of

floating rate instruments, with the majority of those tied to the prime rate.

The following table sets forth the contractual maturities of the Bank's fixed and floating rate loans at December 31, 2008. Amounts presented are shown by maturity dates rather than repricing periods, and do not consider renewals or prepayments of loans:

(In thousands)	Due in one year or less	Due after one Year through Five years	Due after Five years	Total
Accruing loans:				
Fixed rate loans	\$ 42,582	\$ 75,327	\$ 65,020	\$ 182,929
Floating rate loans	231,533	72,300	12,118	315,951
Total accruing loans	274,115	147,627	77,138	498,880
Nonaccrual loans:				
Fixed rate loans	7,783	5,060	591	13,434
Floating rate loans	37,281	0	381	37,662
Total nonaccrual loans	45,064	5,060	972	51,096
Total Loans	\$ 319,179	\$ 152,687	\$ 78,110	\$ 549,976

Securities

Following is a comparison of the amortized cost and approximate fair value of available-for-sale for the three years indicated:

(In thousands)	December 31, 2008				December 31, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
Available-for-sale:								
U.S. Government agencies	\$ 43,110	\$ 1,280	\$ (204)	\$ 44,186	\$ 65,764	\$ 524	\$ (302)	\$ 65,986
Collateralized mortgage obligations								
obligations	39,068	189	(4,991)	34,266	7,782	44	(4)	7,822
Obligations of state and political subdivisions	1,252	28	0	1,280	2,227	54	0	2,281
Other investment securities	13,880	0	(863)	13,017	13,752	0	(426)	13,326
Total available-for-sale	\$ 97,310	\$ 1,497	\$ (6,058)	\$ 92,749	\$ 89,525	\$ 622	\$ (732)	\$ 89,415

(In thousands)	December 31, 2006			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-sale:				
U.S. Government agencies	\$ 69,746	\$ 51	\$ (1,293)	\$ 68,504
Collateralized mortgage obligations				
obligations	17	0	(1)	16
Obligations of state and political subdivisions	2,226	65	(1)	2,290
Other investment securities	13,000	0	(444)	12,556
Total available-for-sale	\$ 84,989	\$ 116	\$ (1,739)	\$ 83,366

Included in other investment securities at December 31, 2008, is a short-term government securities mutual fund totaling \$7.2 million, a CRA-qualified mortgage fund totaling \$4.9 million, and an overnight money-market mutual fund totaling \$880,000. Included in other investment securities at December 31, 2007, is a short-term government securities mutual fund totaling \$7.7 million, a CRA-qualified mortgage fund totaling \$4.9 million, and an overnight money-market mutual fund totaling \$752,000. Included in other investment securities at December 31, 2006, is a short-term government securities mutual fund totaling \$7.7 million, and a CRA-qualified mortgage fund totaling \$4.8 million. The commercial asset-backed trust consists of fixed and floating rate commercial and multifamily mortgage loans. The short-term government securities mutual fund invests in debt securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities, with a maximum duration equal to that of a 3-year U.S. Treasury Note.

There were realized gains on available-for-sale securities totaling \$24,000 and \$27,000 for the years ended December 31, 2008 and 2006, respectively. There were no realized gains or losses on securities available-for-sale during 2007.

There were no realized losses on securities available-for-sale during 2008 or 2006.

Investment securities increased \$3.3 million between December 2007 and December 2008, as U.S. government agencies and municipal bonds were either paid down or matured, and additional funds from maturing loans were utilized to purchase additional investment securities or interest-bearing deposits in other banks. Investment securities increased \$6.0 million between December 2006 and December 2007 primarily as the result of the Legacy merger during February 2007 in which approximately \$6.8 million in U.S Agency securities and \$625,000 in other investment securities were added to the Company's portfolio.

Securities that have been temporarily impaired less than 12 months at December 31, 2008 are comprised of four collateralized mortgage obligations with a weighted average life of 3.66 years, and seven U.S. agency bonds with a weighted average life of 3.18 years. As of December 31, 2008, there were two other investment securities with a total weighted average life of 0.50 years that have been temporarily impaired for twelve months or more. The unrealized losses are due in most part to interest rate changes, as well as credit downgrades in some of the portfolio including three collateralized mortgage obligations. The Company has the ability and intent to hold all investment securities with identified impairments resulting from interest rate changes and credit downgrades to the earlier of the forecasted recovery or the maturity of the underlying investment security. The Company believes that credit downgrades on securities within the portfolio are a result of the severity of the current economic downturn and does not believe the downgrades will result in other-than-temporary impairment of those securities. As a result, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2008

The following summarizes temporarily impaired investment securities at December 31, 2008

(In thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
Securities available for sale:						
U.S. Government agencies	\$ 6,471	\$ (204)	\$ 0	\$ 0	\$ 6,471	\$ (204)
Collateralized mortgage obligations	17,568	(4,991)	0	0	17,568	(4,991)
Obligations of state and political subdivisions	0	0	0	0	0	0
Other investment securities	0	0	12,137	(863)	12,137	(863)
Total impaired securities	\$ 24,039	\$ (5,195)	\$ 12,137	\$ (863)	\$ 36,176	\$ (6,058)

Securities that have been temporarily impaired less than 12 months at December 31, 2007 are comprised of one U.S. government agency collateralized mortgage obligation with a weighted average life of 1.19 years. As of December 31, 2007, there were nine U.S. government agency securities, and two other investment securities with a total weighted average life of 0.97 years that have been temporarily impaired for twelve months or more. Because the decline in market value is attributable to changes in market rates of interest rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2007.

The following summarizes temporarily impaired investment securities at December 31, 2007

(In thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
Securities available for sale:						
U.S. Government agencies	\$ 0	\$ 0	\$ 30,241	\$ (302)	\$ 30,241	\$ (302)
Collateralized mortgage						

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obligations	4,129	(4)	0	0	4,129	(4)
Obligations of state and political subdivisions	0	0	0	0	0	0
Other investment securities	0	0	12,574	(426)	12,574	(426)
Total impaired securities	\$ 4,129	\$ (4)	\$ 42,815	\$ (728)	\$ 46,944	\$ (732)

Securities that have been temporarily impaired less than 12 months at December 31, 2006 are comprised of one U.S. government agency security with a weighted average life of 13.2 years. As of December 31, 2006, there were nineteen U.S. government agency securities, one collateralized mortgage obligation, one municipal security, and two other investment securities with a total weighted average life of 2.29 years that have been temporarily impaired for twelve months or more. Because the decline in market value is attributable to changes in market rates of interest rather than credit quality, and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2006.

The following summarizes temporarily impaired investment securities at December 31, 2006

(In thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
Securities available for sale:						
U.S. Government agencies	\$ 506	\$ (6)	\$ 65,626	\$ (1,287)	\$ 66,132	\$ (1,293)
Collateralized mortgage obligations	0	0	12	(1)	12	(1)
Obligations of state and political subdivisions	0	0	34	(1)	34	(1)
Other investment securities	0	0	12,556	(444)	12,556	(444)
Total impaired securities	\$ 506	\$ (6)	\$ 78,228	\$ (1,733)	\$ 78,734	\$ (1,739)

The contractual maturities of investment securities as well as yields based on amortized cost of those securities at December 31, 2008 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	One year or less		After one year to five years		After five years to ten years		After ten years		Total	
	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)	Amount	Yield (1)
Available-for-sale:										
U.S. Government agencies	\$ 700	3.78%	\$ 3,642	3.65%	\$ 8,601	5.29%	\$ 31,243	4.58%	\$ 44,186	4.70%
Collateralized mortgage obligations	—	—	3,104	4.73%	5,826	4.57%	25,336	6.05%	34,266	5.78%
Obligations of state and political subdivisions	—	—	352	4.37%	928	4.64%	—	—	1,280	4.57%
Other investment securities	13,017	5.11%	—	—	—	—	—	—	13,017	5.11%
Total estimated fair value	\$ 13,717	5.05%	\$ 7,098	4.16%	\$ 15,355	4.98%	\$ 56,579	5.24%	\$ 92,749	5.40%

(1) Weighted average yields are not computed on a tax equivalent basis

At December 31, 2008 and 2007, available-for-sale securities with an amortized cost of approximately \$81.4 million and \$71.0 million, respectively (fair value of \$79.6 million and \$71.3 million, respectively) were pledged as collateral for public funds, FHLB borrowings, and treasury tax and loan balances.

Deposits

The Bank attracts commercial deposits primarily from local businesses and professionals, as well as retail checking accounts, savings accounts and time deposits. Total deposits decreased \$126.1 million or 19.9% during the year to a balance of \$508.5 million at December 31, 2008 and increased \$47.5 million or 8.1% between December 31, 2006 and December 31, 2007. Core deposits, consisting of all deposits other than time deposits of \$100,000 or more and brokered deposits, continue to provide the foundation for the Bank's principal sources of funding and liquidity. These core deposits amounted to 71.9%, 59.9% and 71.0% of the total deposit portfolio at December 31, 2008, 2007 and 2006, respectively.

The following table sets forth the year-end amounts of deposits by category for the years indicated, and the dollar change in each category during the year:

(In thousands)	December 31,			Change during Year	
	2008	2007	2006	2008	2007
Noninterest-bearing deposits	\$ 149,529	\$ 139,066	\$ 159,002	\$ 10,463	\$ (19,936)
Interest-bearing deposits:					
NOW and money market accounts	136,612	153,717	184,384	(17,105)	(30,667)
Savings accounts	37,586	40,012	31,933	(2,426)	8,079
Time deposits:					
Under \$100,000	66,128	52,297	42,428	13,831	9,869
\$100,000 and over	118,631	249,525	169,380	(130,894)	80,145
Total interest-bearing deposits	358,957	495,551	428,125	(136,594)	67,426
Total deposits	\$ 508,486	\$ 634,617	\$ 587,127	\$ (126,131)	\$ 47,490

During the year ended December 31, 2008, decreases were experienced primarily in time deposits, and to a lesser degree in interest-bearing checking accounts and saving accounts. Brokered and other time deposits were allowed to runoff as they matured during 2008, as the Company sought other less-expensive funding sources including FHLB advances and overnight borrowings from the Federal Reserve. In addition, time deposits from the State of California, which totaled \$45.0 million at both December 31, 2007 and December 31, 2006, were not renewed by the State of California during 2008. The Company had increased brokered deposits throughout 2007 as part of its liquidity strategy begun during 2006 to fund loan growth as core deposits became increasingly difficult to obtain and pricing became more competitive. As market rates of interest declined during 2008, brokered deposit pricing did not decline to the same degree, due largely to liquidity and credit issues in the market place. As a result, brokered deposits and other time deposits became less attractive as a funding source. Brokered deposits totaled \$93.4 million, \$139.3 million, and \$67.7 million at December 31, 2008, 2007 and 2006, respectively. The Company will continue to use pricing strategies to control the overall level of time deposits and other borrowings as part of its growth and liquidity planning process. NOW and money market accounts, as well as savings accounts declined \$17.1 million and \$2.4 million, respectively, between December 31, 2007 and December 31, 2008 as these deposits remain competitive. The Company continues to emphasize core deposits as part of its relationship banking strategy. As a result, core deposits, including NOW and money market accounts, and savings accounts, as well as noninterest-bearing checking accounts, continue to provide the Company's primary funding source.

During the year ended December 31, 2007 increases were experienced primarily in time deposits, and to a lesser degree in saving accounts. Increases in time deposits during 2007 were largely the result brokered time deposits obtained by the Company as part of its liquidity strategy begun during 2006 to fund loan growth as core deposits became increasingly difficult to obtain and pricing became more competitive. This liquidity strategy allowed the Company to obtain the additional funding sources needed during 2007 to fund loan growth without adversely impacting the cost of its core deposit base. NOW and money market accounts, as well as noninterest-bearing deposits declined \$30.7 million and \$19.9 million, respectively, between December 31, 2006 and December 31, 2007 as these deposits became increasingly competitive.

During the year ended December 31, 2006 increases were experienced in all deposit categories, except in time deposits under \$100,000 and savings deposits. Increases experienced during 2006 in money market accounts and time deposits in excess of \$100,000 are primarily the result of depositors seeking higher yields during the year as competitors such as brokerage firms and credit unions have drove up rates to attract deposits. Increases in time deposits of \$100,000 and over experienced during 2006 were largely the result of brokered time deposits obtained by the Company as part of its liquidity strategy to fund loan growth during the year.

The Company's deposit base consists of two major components represented by noninterest-bearing (demand) deposits and interest-bearing deposits. Interest-bearing deposits consist of time certificates, NOW and money market accounts and savings deposits. Total noninterest-bearing deposits increased \$10.5 million or 7.5% between December 31, 2007 and December 31, 2008, while interest-bearing deposits decreased \$136.6 million or 27.6% between the same two periods presented. Between December 31, 2006 and December 31, 2007, total interest-bearing deposits increased \$67.4 million or 15.6%, while noninterest-bearing deposits decreased \$19.9 million or 12.5%. Deposit balances acquired in the acquisition of Legacy Bank during February 2007 totaled approximately \$69.6 million. Exclusive of the deposits acquired from Legacy Bank during the first quarter of 2007, deposit balances attributable to the Company's previously existing deposit base decreased approximately \$22.1 million during the year ended December 31, 2007.

On a year-to-date average basis, total deposits decreased \$56.1 million or 8.8% between the years ended December 31, 2007 and December 31, 2008. Of that total, interest-bearing deposits decreased by \$53.9 million or 10.9%, while noninterest-bearing deposits decreased \$2.2 million or 1.5% during 2008. On average, the Company experienced decreases in all deposit categories between the years ended December 31, 2007 and December 31, 2008.

On a year-to-date average, the Company experienced an increase of \$74.3 million or 3.2 % in total deposits between the years ended December 31, 2006 and December 31, 2007. Between these two periods, average interest-bearing deposits increased \$74.1 million or 17.7%, while total noninterest-bearing checking increased \$232,000 or 0.16% on a year-to-date average basis. On average, the Company experienced increases in savings accounts and time deposits between the years ended December 31, 2006 and December 31, 2007, while other deposit categories experienced moderate declines on average during 2007.

The following table sets forth the average deposits and average rates paid on those deposits for the years ended December 31, 2008, 2007 and 2006:

(Dollars in thousands)	2008		2007		2006	
	Average Balance	Rate %	Average Balance	Rate %	Average Balance	Rate %
Interest-bearing deposits:						
Checking accounts	\$ 167,190	1.91%	\$ 183,102	2.48%	\$ 187,360	2.10%
Savings	40,699	1.18%	46,225	1.91%	35,135	0.56%
Time deposits (1)	230,746	3.65%	263,196	4.94%	195,922	4.32%
Noninterest-bearing deposits						
	144,772		146,954		146,722	

(1) Included at December 31, 2008, are \$118.6 million in time certificates of deposit of \$100,000 or more, of which \$48.0 million matures in three months or less, \$48.3 million matures in 3 to 6 months, \$14.2 million matures in 6 to 12 months, and \$8.1 million matures in more than 12 months.

Short-term Borrowings

The Company has the ability to obtain borrowed funds consisting of federal funds purchased, securities sold under agreements to repurchase (“repurchase agreements”) and Federal Home Loan Bank (“FHLB”) advances as alternatives to retail deposit funds. The Company has established collateralized and uncollateralized lines of credit with several correspondent banks, as well as a securities dealer, for the purpose of obtaining borrowed funds as needed. The Company may continue to borrow funds in the future as part of its asset/liability strategy, and may use these funds to acquire certain other assets as deemed appropriate by management for investment purposes and to better utilize the capital resources of the Bank. Federal funds purchased represent temporary overnight borrowings from correspondent banks and are generally unsecured. Repurchase agreements are collateralized by mortgage backed securities and securities of U.S. Government agencies, and generally have maturities of one to six months, but may have longer maturities if deemed appropriate as part of the Company’s asset/liability management strategy. FHLB advances are collateralized by the Company’s investment in FHLB stock, securities, and certain qualifying mortgage loans. In addition, the Company has the ability to obtain borrowings from the Federal Reserve Bank of San Francisco, which would be collateralized by certain pledged loans in the Company’s loan portfolio. The lines of credit are subject to periodic review of the Company’s financial statements by the grantors of the credit lines. Lines of credit may be modified or revoked at any time if the grantors feel there are adverse trends in the Company’s financial position.

The Company had collateralized and uncollateralized lines of credit aggregating \$242.7 million and \$386.7 million, as well as FHLB lines of credit totaling \$97.1 million and \$22.0 million at December 31, 2008 and 2007, respectively. At December 31, 2008, the Company had total outstanding balances of \$88.5 million drawn against its FHLB line of credit. Of the \$88.5 million in FHLB borrowings outstanding at December 31, 2008, \$77.5 million was in borrowings with maturities of one year or less with an average rate of 1.05%, and the other \$11.0 million consists of a two-year FHLB advance, with an average fixed rate of 2.67%. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR.

The table below provides further detail of the Company’s federal funds purchased, repurchase agreements and FHLB advances for the years ended December 31, 2008, 2007 and 2006:

(Dollars in thousands)	2008	December 31, 2007	2006
At period end:			

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Federal funds purchased	\$ 66,545	\$ 10,380	\$ 0
Repurchase agreements	0	0	0
FHLB advances	88,500	21,900	0
Total at period end	\$ 155,045	\$ 32,280	\$ 0
Average ending interest rate – total	0.93%	4.10%	0.00%
Average for the year:			
Federal funds purchased	\$ 58,432	\$ 4,660	\$ 4,209
Repurchase agreements	0	0	0
FHLB advances	32,937	13,231	0
Total average for the year	\$ 91,369	\$ 17,891	\$ 4,209
Average interest rate – total	2.32%	5.17%	5.30%
Maximum total borrowings outstanding at any month-end during the year:			
Federal funds purchased	\$ 160,083	\$ 16,400	\$ 17,100
Repurchase agreements/FHLB advances	28,000	20,000	0
Total	\$ 188,083	\$ 36,400	\$ 17,100

Asset Quality and Allowance for Credit Losses

Lending money is the Company's principal business activity, and ensuring appropriate evaluation, diversification, and control of credit risks is a primary management responsibility. Implicit in lending activities is the fact that losses will be experienced and that the amount of such losses will vary from time to time, depending on the risk characteristics of the loan portfolio as affected by local economic conditions and the financial experience of borrowers.

The allowance for credit losses is maintained at a level deemed appropriate by management to provide for known and inherent risks in existing loans and commitments to extend credit. The adequacy of the allowance for credit losses is based upon management's continuing assessment of various factors affecting the collectibility of loans and commitments to extend credit; including current economic conditions, past credit experience, collateral, and concentrations of credit. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The collectibility of a loan is subjective to some degree, but must relate to the borrower's financial condition, cash flow, quality of the borrower's management expertise, collateral and guarantees, and the state of the local economy. When determining the adequacy of the allowance for credit losses, the Company follows, in accordance with GAAP, the guidelines set forth in the Interagency Policy Statement on the Allowance for Loan and Lease Losses ("Statement") issued jointly by banking regulators during 2003, and updated and revised in 2006. The Statement outlines characteristics that should be used in segmentation of the loan portfolio for purposes of the analysis including risk classification, past due status, type of loan, industry or collateral. It also outlines factors to consider when adjusting the loss factors for various segments of the loan portfolio. Securities and Exchange Commission Staff Accounting Bulletin No. 102 was also released at this time which represents the SEC staff's view relating to methodologies and supporting documentation for the Allowance for Loan and Lease Losses that should be observed by all public companies in complying with the federal securities laws and the Commission's interpretations. It is also generally consistent with the guidance published by the banking regulators.

The Company segments the loan and lease portfolio into eleven (11) segments, primarily by loan class and type, that have homogeneity and commonality of purpose and terms for analysis under SFAS No. 5. Those loans which are determined to be impaired under SFAS No. 114 are not subject to the general reserve analysis under SFAS No. 5, and evaluated individually for specific impairment. The eleven segments of the Company's loan portfolio are as follows (subtotals are provided as needed to allow the reader to reconcile the amounts to the Company's loan classification reported elsewhere in these financial statements):

Loan Segments for Loan Loss Reserve Analysis		Loan Balance at December 31,				
(dollars in 000's)		2008	2007	2006	2005	2004
1	Commercial and Business Loans	\$ 216,552	\$ 196,682	\$ 152,070	\$ 109,783	\$ 115,831
2	Government Program Loans	7,029	7,703	3,741	3,480	7,889
	Total Commercial and Industrial	223,581	204,385	155,811	113,263	123,720
3	Commercial Real Estate Term Loans	81,840	102,399	71,697	43,644	62,501
4	Single Family Residential Loans	41,608	37,194	39,184	43,308	21,567
5	Home Improvement/Home Equity Loans	3,241	2,972	2,732	2,551	4,119
	Total Real Estate Mortgage	126,689	142,565	113,613	89,503	88,187

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	Total Real Estate					
6	Construction Loans	119,885	178,296	168,378	162,873	137,523
7	Total Agricultural Loans	52,020	46,055	35,102	24,935	23,416
8	Consumer Loans	20,370	17,521	16,327	14,373	12,476
9	Overdraft protection Lines	80	85	82	102	117
10	Overdrafts	332	565	303	527	664
	Total Installment/other	20,782	18,171	16,712	15,002	13,257
11	Total Lease Financing	7,020	8,748	10,952	12,334	12,581
	Total Loans	\$ 549,977	\$ 598,220	\$ 500,568	\$ 417,910	\$ 398,684

The Company's methodology for assessing the adequacy of the allowance for credit losses consists of several key elements, which include:

- the formula allowance,
- specific allowances for problem graded loans ("classified loans")
- and the unallocated allowance

In addition, the allowance analysis also incorporates the results of measuring impaired loans as provided in:

- Statement of Financial Accounting Standards ("SFAS") No. 114, "Accounting by Creditors for Impairment of a Loan" and
- SFAS 118, "Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures."

The formula allowance is calculated by applying loss factors to outstanding loans and certain unfunded loan commitments. Loss factors are based on the Company's historical loss experience and on the internal risk grade of those loans and, may be adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date. Factors that may affect collectibility of the loan portfolio include:

- Levels of, and trends in delinquencies and nonaccrual loans;
- Trends in volumes and term of loans;
- Effects of any changes in lending policies and procedures including those for underwriting, collection, charge-off, and recovery;
- Experience, ability, and depth of lending management and staff;
- National and local economic trends and conditions and;
- Concentrations of credit that might affect loss experience across one or more components of the portfolio, including high-balance loan concentrations and participations.

Management determines the loss factors for problem-graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates loan losses over the past twelve quarters (three years) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in the Company's loan portfolio. For purposes of this analysis, loans are grouped by internal risk classifications, which are "pass", "special mention", "substandard", "doubtful", and "loss." Certain loans are homogenous in nature and are therefore pooled by risk grade. These homogenous loans include consumer installment and home equity loans. Special mention loans are currently performing but are potentially weak, as the borrower has begun to exhibit deteriorating trends, which if not corrected, could jeopardize repayment of the loan and result in further downgrade. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as "doubtful" has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include loans categorized as substandard, doubtful, and loss. At December 31, 2008 problem graded or "classified" loans totaled \$88.1 million or 16.0% of gross loans, as compared to \$105.1 million or 17.3% of gross loans at September 30, 2008, and \$51.8 million or 8.7% of gross loans at December 31, 2007.

Loan participations are reviewed for allowance adequacy under the same guidelines as other loans in the Company's portfolio, with an additional participation factor added, if required, for specific risks associated with participations. In general, participations are subject to certain thresholds set by the Company, and are reviewed for geographic location as well as the well-being of the underlying agent bank.

The formula allowance includes reserves for certain off-balance sheet risks including letters of credit, unfunded loan commitments, and lines of credit. Reserves for undisbursed commitments are generally formula allocations based on

the Company's historical loss experience and other loss factors, rather than specific loss contingencies. At December 31, 2008, 2007 and 2006 the formula reserve allocated to undisbursed commitments totaled \$313,000, \$548,000 and \$526,000, respectively.

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in classified loans, impaired loans, and other loans in which management believes there is a probability that a loss has been incurred in excess of the amount determined by the application of the formula allowance. Specific allowance amounts include those calculated under SFAS No. 114. Under SFAS No. 114, for impaired loans, specific allowances are determined based on the collateralized value of the underlying properties, the net present value of the anticipated cash flows, or the market value of the underlying assets. Under SFAS No. 5, for classified loans excluding impaired loans, specific allowances, where required, are determined on the basis of additional risks involved with individual loans that may be in excess of risk factors associated with the loan portfolio as a whole. The specific allowance is different from the formula allowance in that the specific allowance is determined on a loan-by-loan basis based on risk factors directly related to a particular loan, as opposed to the formula allowance which is determined for a pool of loans with similar characteristics, based on past historical trends and other risk factors which may be relevant on an ongoing basis.

The unallocated portion of the allowance is the result of both expected and unanticipated changes in various conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, and other business conditions.

The following table summarizes the specific allowance, formula allowance, and unallocated allowance at December 31, 2008, September 30, 2008 and December 31, 2007.

(in 000's)	Balance December 31, 2008	Balance September 30, 2008	Balance December 31, 2007
Specific allowance – impaired loans	\$ 8,514	\$ 7,953	\$ 4,452
Formula allowance – special mention and classified loans	2,865	3,860	\$ 2,459
Total allowance for special mention and classified loans	11,379	11,813	6,911
Formula allowance for pass loans	3,550	3,973	3,990
Unallocated allowance	142	320	0
Total allowance	\$ 15,071	\$ 16,106	\$ 10,901

Impaired loans increased approximately \$33.7 million between December 31, 2007 and December 31, 2008, and increased approximately \$717,000 million during the quarter ended December 31, 2008. The specific allowance related to impaired loans increased \$4.1 million and \$561,000 for the year ended and quarter ended December 31, 2008, respectively. The formula allowance related to loans that are not impaired (including special mention and substandard) increased approximately \$407,000 between December 31, 2007 and December 31, 2008, but decreased \$995,000 during the quarter ended December 31, 2008. Increases for the year ended December 31, 2008 were the result of increases in the volume of substandard and special mention loans, as well as minor increases in adjusting factors for current economic trends and conditions, and trends in delinquent and nonaccrual loans. Even though the level of "pass" loans decreased approximately \$104.2 million during the year ended December 31, 2008, the related formula allowance decreased only \$441,000 during 2008 as a result of an increase in commercial and industrial loans which have a higher percentage loss allocation, as well as factor allocation increases due to current economic conditions.

At December 31, 2008, the Company segregated approximately \$26.3 million of the total \$33.8 million in substandard classified loans for purposes of the quarterly analysis of the adequacy of the allowance for credit losses under SFAS No. 5. Many of these loans had been downgraded to substandard because the borrowers had other direct or indirect lending relationships which were classified as substandard or impaired. The \$26.3 million in substandard loans

consists of ten borrowing relationships, which although classified as substandard, the Company believes are performing and therefore do not warrant the same loss factors as other substandard loans in the portfolio. The adequacy of the allowance for credit losses related to this \$26.3 million pool of substandard loans was based upon current payment history, loan-to-value ratios, future anticipated performance, and other various factors. The formula allowance for credit losses related to these substandard loans totaled \$1.2 million at December 31, 2008. This formula reserve is included in the formula allowance for special mention and classified loans totaling \$2.9 million in the table above.

The Company's methodology includes features that are intended to reduce the difference between estimated and actual losses. The specific allowance portion of the analysis is designed to be self-correcting by taking into account the current loan loss experience based on that portion of the portfolio. By analyzing the probable estimated losses inherent in the loan portfolio on a quarterly basis, management is able to adjust specific and inherent loss estimates using the most recent information available. In performing the periodic migration analysis, management believes that historical loss factors used in the computation of the formula allowance need to be adjusted to reflect current changes in market conditions and trends in the Company's loan portfolio. There are a number of other factors, which are reviewed when determining adjustments in the historical loss factors. They include 1) trends in delinquent and nonaccrual loans, 2) trends in loan volume and terms, 3) effects of changes in lending policies, 4) concentrations of credit, 5) competition, 6) national and local economic trends and conditions, 7) experience of lending staff, 8) loan review and Board of Directors oversight, 9) high balance loan concentration, and 10) other business conditions. Other than the segregation of approximately \$26.3 million in substandard loans at December 31, 2008 discussed above, there were no changes in estimation methods or assumptions during 2008 that affected the methodology for assessing the overall adequacy of the allowance for credit losses.

Management and the Company's lending officers evaluate the loss exposure of classified and impaired loans on a weekly and monthly basis, and through discussions and officer meetings as conditions change. The Company's Loan Committee meets weekly and serves as a forum to discuss specific problem assets that pose significant concerns to the Company, and to keep the Board of Directors informed through committee minutes. All special mention and classified loans are reported quarterly on Criticized Asset Reports, which are reviewed by senior management. With this information, the migration analysis and the impaired loan analysis are performed on a quarterly basis and adjustments are made to the allowance as deemed necessary. As the real estate market and economic crisis became more severe during the later part of 2008, the Company successfully worked with many of its borrowers to re-margin loans as collateral values declined, weakening the Company's credit position and increasing the potential for losses. This process of working with potentially troubled borrowers was monitored closely through the loan review process.

Impaired loans are calculated under SFAS No. 114, and are measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. The amount of impaired loans is not directly comparable to the amount of nonperforming loans disclosed later in this section. The primary differences between impaired loans and nonperforming loans are: i) all loan categories are considered in determining nonperforming loans while impaired loan recognition is limited to commercial and industrial loans, commercial and residential real estate loans, construction loans, and agricultural loans, and ii) impaired loan recognition considers not only loans 90 days or more past due, restructured loans and nonaccrual loans but also may include problem loans other than delinquent loans.

The Company considers a loan to be impaired when, based upon current information and events, it believes it is probable the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans include nonaccrual loans, restructured debt, and performing loans in which full payment of principal or interest is not expected. Management bases the measurement of these impaired loans on the fair value of the loan's collateral or the expected cash flows on the loans discounted at the loan's stated interest rates. Cash receipts on impaired loans not performing to contractual terms and that are on nonaccrual status are used to reduce principal balances. Impairment losses are included in the allowance for credit losses through a charge to the provision, if applicable.

At December 31, 2008 and 2007, the Company's recorded investment in loans for which impairment has been recognized totaled \$54.4 million and \$20.6 million, respectively. Included in total impaired loans at December 31, 2008, are \$31.0 million of impaired loans for which the related specific allowance is \$8.5 million, as well as \$23.4 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. Total impaired loans at December 31, 2007 included \$10.7 million of impaired loans for which the related specific allowance is \$4.5 million, as well as \$9.9 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. The average recorded investment in impaired loans was \$37.1 million, \$15.9 million and \$10.1 million during the years ended December 31, 2008, 2007 and 2006, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms, income is recognized under the accrual method. For the years ended December 31, 2008 and 2007, the Company recognized no income on such loans. For the year ended December 31, 2006 the Company recognized income of \$65,000 on such loans.

The greatest increase in impaired loans during the year ended December 31, 2008 has been in real estate construction loans, with that loan category comprising more than 53% of total impaired loans at December 31, 2008. Impaired construction loans decreased \$10.9 million during the fourth quarter of 2008, partially as the result of the transfer of approximately \$23.2 million in construction loans from impaired status to OREO during the fourth quarter of 2008.

Although construction loans are generally collateral dependent and the related collateral is considered adequate to cover the loan's carrying value in many cases, the specific reserve related to impaired construction loans has increased

approximately \$1.7 million since December 31, 2007 as property valuations have declined. Specific collateral related to impaired loans is reviewed for current appraisal information, economic trends within geographic markets, loan-to-value ratios, and other factors that may impact the value of the loan collateral. Adjustments are made to collateral values as needed for these factors. Of total impaired loans, approximately \$39.5 million or 72.7% are secured by real estate, and \$34.0 million of total impaired loans are for the purpose of residential construction, residential and commercial acquisition and development, and land development. Residential construction loans are made for the purpose of building residential 1-4 single family homes. Residential and commercial acquisition and development loans are made for the purpose of purchasing land, and developing that land if required, and to develop real estate or commercial construction projects on those properties. Land development loans are made for the purpose of converting raw land into construction-ready building sites. The following table summarizes the components of impaired loans and their related specific reserves at December 31, 2008, September 30, 2008 and December 31, 2007.

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(in 000's)	Balance December 31, 2008	Reserve December 31, 2008	Balance Sept 30, 2008	Reserve Sept 30, 2008	Balance December 31, 2007	Reserve December 31, 2007
Commercial and industrial	\$ 12,244	\$ 2,340	\$ 7,831	\$ 294	\$ 7,617	\$ 339
Real estate – mortgage	3,689	226	600	0	0	0
Real estate – construction	28,927	2,338	39,799	4,133	7,474	598
Agricultural	4,086	68	0	0	0	0
Installment/other	0	0	0	0	0	0
Lease financing	5,425	3,542	5,425	3,526	5,536	3,516
Total	\$ 54,371	\$ 8,514	\$ 53,655	\$ 7,953	\$ 20,627	\$ 4,453

Of the \$28.9 million in impaired construction loans shown above at December 31, 2008, approximately \$13.6 million or 25.1% are for residential construction \$15.3 million or 28.1 % are for land development. Of the \$12.2 million in impaired commercial and industrial loans at December 31, 2008, more than \$1.8 million or 14.7% are for residential construction. Geographically, the \$34.0 million in impaired loans made for the purpose of residential construction, residential and commercial acquisition and development, and land development, are disbursed throughout a wide area of California, with approximately 27.4% of those loans within Fresno, Madera, Kern, and Santa Clara Counties. The following table summarizes the impaired loan balances by county of loans made for the purpose of residential construction, residential and commercial acquisition and development, and land development as of December 31, 2008.

County:	Impaired Balance (000's)	Percentage
Fresno	\$ 229	0.67%
Madera	2,923	8.61%
Kern	4,991	14.70%
Santa Clara	1,161	3.42%
Alpine	7,973	23.49%
San Mateo	2,103	6.19%
Mariposa	1,084	3.19%
Merced	2,524	7.43%
Monterey	7,781	22.92%
Sacramento	1,425	4.20%
Sonoma	1,156	3.41%
Other counties	600	1.77%
Total R.E. related impaired	\$ 33,950	100.00%

The Company focuses on competition and other economic conditions within its market area and other geographical areas in which it does business, which may ultimately affect the risk assessment of the portfolio. The Company continues to experience increased competition from major banks, local independents and non-bank institutions creating pressure on loan pricing. With interest rates decreasing 100 basis points during the fourth quarter of 2007, another 400 basis points during 2008, indications are that the economy will continue to suffer in the near future as a result of sub-prime lending problems, a weakened real estate market, and tight credit markets. Both business and consumer spending have slowed during the past several quarters, and current GDP projections for the next year have softened significantly. It is difficult to determine to what degree the Federal Reserve will adjust short-term interest rates in its efforts to influence the economy, or what magnitude government economic support programs will reach. It is likely that the business environment in California will continue to be influenced by these domestic as well as global events. The local market has remained relatively more stable economically during the past several years than other areas of the state and the nation, which have experienced more volatile economic trends, including significant

deterioration of residential real estate markets. Although the local area residential housing markets have been hit hard, they continue to perform better than other parts of the state, which should bode well for sustained, but slower growth in the Company's market areas of Fresno and Madera, Kern, and Santa Clara Counties. Local unemployment rates in the San Joaquin Valley remain high primarily as a result of the areas' agricultural dynamics, however unemployment rates have increased recently as the national economy has declined. It is difficult to predict what impact this will have on the local economy. The Company believes that the Central San Joaquin Valley will continue to grow and diversify as property and housing costs remain reasonable relative to other areas of the state. Management recognizes increased risk of loss due to the Company's exposure from local and worldwide economic conditions, as well as potentially volatile real estate markets, and takes these factors into consideration when analyzing the adequacy of the allowance for credit losses.

The following table provides a summary of the Company's allowance for credit losses, provisions made to that allowance, and charge-off and recovery activity affecting the allowance for the years indicated.

(Dollars in thousands)	December 31,				
	2008	2007	2006	2005	2004
Total loans outstanding at end of period before deducting allowances for credit losses	\$ 548,742	\$ 596,480	\$ 499,570	\$ 417,156	\$ 397,584
Average net loans outstanding during period	\$ 587,925	\$ 580,873	\$ 469,959	\$ 402,820	\$ 374,748
Balance of allowance at beginning of period	\$ 10,901	\$ 8,365	\$ 7,748	\$ 7,251	\$ 6,081
Loans charged off:					
Real estate	(3,103)	(22)	0	0	0
Commercial and industrial	(1,890)	(4,286)	(290)	(323)	(14)
Lease financing	(281)	(8)	(164)	(364)	(496)
Installment and other	(271)	(177)	(48)	(86)	(80)
Total loans charged off	(5,545)	(4,493)	(502)	(773)	(590)
Recoveries of loans previously charged off:					
Real estate	0	0	0	0	0
Commercial and industrial	92	46	195	108	82
Lease financing	14	0	1	3	29
Installment and other	11	18	43	54	25
Total loan recoveries	117	64	239	165	136
Net loans charged off	(5,428)	(4,429)	(263)	(608)	(454)
Reclassification of off-balance sheet reserve	0	0	0	(35)	(507)
Reserve acquired in business acquisition	0	1,268	0	0	986
Provision charged to operating expense	9,598	5,697	880	1,140	1,145
Balance of allowance for credit losses at end of period	\$ 15,071	\$ 10,901	\$ 8,365	\$ 7,748	\$ 7,251
Net loan charge-offs to total average loans	0.92%	0.76%	0.06%	0.15%	0.12%
Net loan charge-offs to loans at end of period	0.99%	0.74%	0.05%	0.15%	0.11%
Allowance for credit losses to total loans at end of period	2.75%	1.83%	1.67%	1.86%	1.82%
Net loan charge-offs to allowance for credit losses	36.02%	40.63%	3.14%	7.85%	6.26%
Net loan charge-offs to provision for credit losses	56.55%	77.74%	29.89%	53.33%	39.65%

Management believes that the 2.75% credit loss allowance to total loans at December 31, 2008 is adequate to absorb known and inherent risks in the loan portfolio. No assurance can be given, however, that the economic conditions which may adversely affect the Company's service areas or other circumstances will not be reflected in increased losses in the loan portfolio. Management is not currently aware of any conditions that may adversely affect the levels of losses incurred in the Company's loan portfolio.

Although the Company does not normally allocate the allowance for credit losses to specific loan categories, an allocation to the major categories has been made for the purposes of this report as set forth in the following table. The allocations are estimates based on the same factors as considered by management in determining the amount of additional provisions to the credit loss allowance and the overall adequacy of the allowance for credit losses.

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(Dollars in thousands)	2008		2007		2006		2005		2004	
	Allowance		Allowance		Allowance		Allowance		Allowance	
	for Credit Losses	% of Loans	for Credit Losses	% of Loans	For Credit Losses	% of Loans	for Credit Losses	% of Loans	for Credit Losses	% of Loans
Commercial and industrial	\$ 5,829	40.7%	\$ 3,254	34.2%	\$ 1,905	31.1%	\$ 1,397	27.1%	\$ 2,497	31.0%
Real estate – mortgage	715	23.0%	593	23.8%	619	22.7%	330	21.4%	386	22.1%
Real estate – construction	3,658	21.7%	2,824	29.8%	1,039	33.7%	1,598	38.9%	1,753	34.5%
Agricultural	1,035	9.5%	559	7.7%	310	7.0%	316	6.0%	197	5.9%
Installment/other	101	3.8%	133	3.0%	187	3.3%	112	3.6%	103	3.3%
Lease financing	3,591	1.3%	3,538	1.5%	4,165	2.2%	3,619	3.0%	2,312	3.2%
Not allocated	142	—	0	—	140	—	376	—	3	—
	\$ 15,071	100.0%	\$ 10,901	100.0%	\$ 8,365	100.0%	\$ 7,748	100.0%	\$ 7,251	100.0%

During 2008, reserve allocations increased significantly for commercial and industrial loans, and to lesser extent, construction and agricultural loans. As with prior years, the significant reserve allocation for lease financing loans is the result of specific reserves allocated to a lease portfolio that has been nonperforming since 2002 and is in the process of litigation (see discussion following). Increased reserve allocations for commercial and industrial loans, construction loans, as well as agricultural loans, are the result of increases in special mention and substandard loans in those categories, with an increase in the volume of loans considered impaired. Successful re-margining of a number of the Company's problem loans during the third and fourth quarters of 2008 helped to reduce potential loss exposure in the loan portfolio.

During 2007, reserve allocations increased significantly for commercial and industrial loans, construction loans, and to lesser extent, agricultural loans. Increased reserve allocations for commercial and industrial loans, as well as agricultural loans are the result of increased loan volume, as well as increases in substandard loans in those categories. Increases in reserve allocations for construction loans are primarily the result of increases in special mention and substandard loans in those categories. Reserve allocations decreased for lease financing loans as a result of positive results in the litigation process related to the Company's nonperforming purchased lease portfolio.

During 2006, reserve allocations increased for commercial and industrial loans, leasing financing, real estate mortgage loans, and installment loans. Increased reserve allocations for commercial and industrial loans are the result of increased loan volume, while increases in reserve allocations for real estate mortgage and installment loans are primarily the result of increases in substandard loans in those categories. Reserve allocations decreased for real estate construction loans as a result of significant decreases in the level of substandard loans in that category between December 31, 2005 and December 31, 2006.

The Company believes that under generally accepted accounting principles, a total loss of principal is not probable at this time and the specific allowance of \$3.5 million calculated for the impaired lease portfolio at December 31, 2008 under SFAS No. 114 is in accordance with GAAP.

During a regulatory examination in the fourth quarter of 2003, the lease portfolio in question was classified as doubtful by the Bank's regulators based upon state regulatory guidelines. California Financial Code No. 1951 requires that a credit, where interest is past due and unpaid for more than one year and is not well secured and not in the process of collection, be charged off. The regulators requested that the Bank charge-off the principal balance in the first or second quarter of 2004 for regulatory purposes if the judge had not made a ruling on the case by March 31, 2004 or, if a ruling had been made but no principal payments have been received by June 30, 2004. The court did not rule by March 31, 2004, and has not made a final ruling on the case at the time of this 10-K filing. As a result,

effective March 31, 2004, the Company charged off the entire \$5.5 million principal balance for regulatory purposes. As a result of the regulatory charge-off, the Company carries a difference between its regulatory accounting principles (RAP) books and its generally accepted accounting principles (GAAP) books. The financial entries made for regulatory reporting purposes resulted in a \$5.5 million reduction in loan balances with a corresponding reduction in the reserve for credit losses. Additional provisions for credit losses of \$3.5 million were also required for regulatory accounting purposes, which resulted in a reduction of \$2.1 million in regulatory net income (net tax benefit of \$1.3 million) for the year ended December 31, 2004 as compared to the financial statements presented under GAAP in the Company's 2004 Annual Report on Form 10-K.

The following summarizes the Company's allowance for credit losses related to the specific, formula, and unallocated reserves for the year-ends shown:

(Dollars in 000's)	December 31,				
	2008	2007	2006	2005	2004
Formula allowance	\$ 3,550	\$ 3,990	\$ 3,637	\$ 2,976	\$ 2,827
Specific allowance	11,379	6,911	4,588	4,396	4,421
Unallocated allowance	142	0	140	376	3
Total allowance	\$ 15,071	\$ 10,901	\$ 8,365	\$ 7,748	\$ 7,251

At December 31, 2008, the allowance for credit losses totaled \$15.1 million, and consisted of \$3.6 million in formula allowance, \$11.4 million in specific allowance, and \$142,000 in unallocated reserve. At December 31, 2008, \$3.6 million of the specific allowance was allocated to lease financing loans, and the remaining \$3.7 million, \$3.0 million, \$801,000, \$215,000, and \$91,000 were allocated to commercial and industrial loans, real estate construction loans, agricultural loans, commercial real estate loans, residential real estate loans, respectively.

At December 31, 2007, the allowance for credit losses totaled \$10.9 million, and consisted of \$4.0 million in formula allowance, and \$6.9 million in specific allowance. At December 31, 2007, \$3.5 million of the specific allowance was allocated to lease financing loans, and the remaining \$40,000, \$311,000, \$38,000, \$1.0 million and \$2.0 million were allocated to commercial real estate, agricultural, installment, commercial and industrial loans, and real estate construction loans, respectively.

The allowance for credit losses totaled \$8.4 million at December 31, 2006, and consisted of \$3.6 million in formula allowance, \$4.6 million in specific allowance, and \$140,000 in unallocated allowance. At December 31, 2006, \$4.0 million of the specific allowance was allocated to lease financing loans, and the remaining \$227,000, \$111,000, \$76,000, \$69,000 and \$58,000 were allocated to commercial real estate, agricultural, installment, commercial and industrial loans, and real estate construction loans, respectively.

The total formula allowance decreased approximately \$440,000 between 2007 and 2008, primarily as the result of decreased volume in "pass" loans. The formula allowance for construction loans decreased \$262,000 during 2008, and the decreased \$131,000 for commercial real estate loans, with only minor changes in other loan categories. Between December 31, 2007 and December 31, 2008, sub-substandard loans increased \$34.8 million, while special mention and doubtful loans increased \$21.1 million and \$1.6 million, respectively. Increases in loan downgrades experienced during 2008 were primarily the result of continued deterioration in the overall economy, including the residential construction market, which in turn has impacted other sectors of the lending portfolio.

The total formula allowance increased approximately \$353,000 between 2006 and 2007, primarily as the result of increased volume in "pass" loans. There were only minor formula allowance allocation changes between loan categories occurring between December 31, 2006 and December 31, 2007, and so most changes in the formula allowance during 2007 were the result of volume changes. Between December 31, 2006 and December 31, 2007, sub-substandard loans increased \$35.0 million, while special mention and doubtful loans increased \$8.6 million and \$891,000 million, respectively. Increases in loan downgrades experienced during 2007 were primarily the result of deteriorating economic factors in the residential construction market, which in turn has impacted other sectors of the lending portfolio.

Although in some instances, the downgrading of a loan resulting from the factors used by the Company in its allowance analysis has been reflected in the formula allowance, management believes that in some instances, the impact of material events and trends has not yet been reflected in the level of nonperforming loans or the internal risk grading process regarding these loans. Accordingly, the Company's evaluation of probable losses related to these factors may be reflected in the unallocated allowance. The evaluation of the inherent losses concerning these factors involve a higher degree of uncertainty because they are not identified with specific problem credits, and therefore the Company does not spread the unallocated allowance among segments of the portfolio. At December 31, 2008, the Company had an unallocated allowance of \$142,000. At December 31, 2007 the Company had no unallocated allowance, reflecting a decrease from the balance of \$140,000 at December 31, 2006. Management's estimates of the unallocated allowance are based upon a number of underlying factors including 1) the effect of deteriorating national and local economic trends, 2) the effects of export market conditions on certain agricultural and manufacturing borrowers, 3) the effects of abnormal weather patterns on agricultural borrowers, as well as other borrowers that may be impacted by such conditions, 4) the effect of increased competition in the Company's market area and the resultant

potential impact of more relaxed underwriting standards to borrowers with multi-bank relationships, 5) the effect of soft real estate markets, and 6) the effects of having a larger number of borrowing relationships which are close to the Company's lending limit, any one if which were not to perform to contractual terms, would have a material impact on the allowance.

The Company's loan portfolio has concentrations in commercial real estate, commercial, and construction loans, however these portfolio percentages fall within the Company's loan policy guidelines.

It is the Company's policy to discontinue the accrual of interest income on loans for which reasonable doubt exists with respect to the timely collectibility of interest or principal due to the inability of the borrower to comply with the terms of the loan agreement. Such loans are placed on nonaccrual status whenever the payment of principal or interest is 90 days past due or earlier when the conditions warrant, and interest collected is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectibility of the net carrying amount of the loan. Management may grant exceptions to this policy if the loans are well secured and in the process of collection.

The following table sets forth the Company's nonperforming assets as of the dates indicated:

(Dollars in thousands, except footnote)	December 31,				
	2008	2007	2006	2005	2004
Nonaccrual loans (1)	\$ 51,096	\$ 21,583	\$ 8,138	\$ 13,930	\$ 16,682
Restructured loans	0	23	4,906	0	0
Total non-performing loans	51,096	21,606	13,044	13,930	16,682
Other real estate owned	30,153	6,666	1,919	4,356	1,615
Total non-performing assets	\$ 81,249	\$ 28,272	\$ 14,963	\$ 18,286	\$ 18,297
Loans, past due 90 days or more, still accruing	\$ 680	\$ 189	\$ 0	\$ 0	\$ 375
Non-performing loans to total loans	9.29%	3.61%	2.61%	3.33%	4.18%
Non-performing assets to total gross loans	14.77%	4.73%	2.99%	4.38%	4.59%

(1) Included in nonaccrual loans at December 31, 2008 are restructured loans totaling \$378,000. There were no nonaccrual loans at December 31, 2007 and 2006, which are restructured. The interest income that would have been earned on nonaccrual loans outstanding at December 31, 2008 in accordance with their original terms is approximately \$3.7 million.

Non-performing assets have increased between December 31, 2007 and December 31, 2008 as declines in real estate markets and related sectors experienced since the later part of 2007 resulting from lending problems continued to impact credit markets and the general economy throughout 2008. Nonaccrual loans increased \$29.5 million between December 31, 2007 and December 31, 2008, with construction loans comprising approximately 57% of total nonaccrual loans at December 31, 2008, and commercial and industrial loans comprising another 19%. The following table summarizes the nonaccrual totals by loan category for the periods shown..

Non-performing assets increased between December 31, 2006 and December 2007 as housing markets and related sectors experienced declines during the second half of the year as a result of sub-prime lending problems which impacted credit markets and the overall economy worldwide. Economic conditions in the San Joaquin Valley remained strong during much of 2007, although as a result of the decline in the housing sector and related real estate valuations, nonperforming assets increased during the years and additional charge-offs were taken during the third and fourth quarters of 2007. Non-performing assets increased during 2007, totaling 4.73% of total loans at December 31, 2007 as compared to 2.99% of total loans at December 31, 2006. Non-performing loans, a component of non-performing assets, increased nearly \$8.6 million during 2007 primarily as the result of real estate construction and real estate development loans which become impaired during the period. Some, but not all, of these nonperforming real estate credits were outside the Company's immediate market area, specifically Southern California and the San Francisco Bay area.

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The following table summarizes the nonaccrual totals by loan category for the periods shown:

Nonaccrual Loans (in 000's):	Balance December 31, 2008	Balance September 30, 2008	Balance December 31, 2007	Change from September 30, 2008	Change from December 31, 2007
Commercial and industrial	\$ 9,507	\$ 8,766	\$ 6,372	\$ 741	\$ 3,135
Real estate - mortgage	3,714	1,747	428	1,967	3,286
Real estate - construction	28,927	39,088	7,548	(10,161)	21,379
Agricultural	3,406	0	1,684	3,406	1,722
Installment/other	55	20	3	35	52
Lease financing	5,486	5,495	5,548	(9)	(62)
Total Nonaccrual Loans	\$ 51,095	\$ 55,116	\$ 21,583	\$ (4,021)	\$ 29,512

Increases in nonaccrual construction loans between December 31, 2007 and December 31, 2008 are the result of a significant slowdown in new housing starts and the resultant depreciation in land, and both partially completed and completed construction projects. Nonaccrual construction loans decreased \$10.2 million during the fourth quarter of 2008, primarily as the result of construction loans that were transferred to other real estate owned. As with impaired loans, a large percentage of nonaccrual loans were made for the purpose of residential construction, residential and commercial acquisition and development, and land development. The following table summarizes nonaccrual balances by purpose at December 31, 2008.

(in 000's)	December 31, 2008
Residential construction	\$ 17,386
Residential and commercial acquisition and development	450
Land development	16,043
Other purposes	17,217
Total nonaccrual loans	\$ 51,096

During the nine months ended September 30, 2008, five loans totaling approximately \$2.7 million were transferred from nonaccrual status to other real estate owned, and during the quarter ended December 31, 2008, an additional nine loans totaling \$25.7 million were transferred to other real estate owned, bringing the total OREO balance to \$31.2 million at December 31, 2008. Charges to the reserve for loan and lease losses at the time of transfer to other real estate owned to record the underlying collateral at fair value totaled \$2.5 million for the year ended December 31, 2008. Non-performing assets totaled 10.68% of total loans at December 31, 2008 as compared to 4.73% of total loans at December 31, 2007.

A nonaccrual land development loan transferred to other real estate owned during the fourth quarter of 2007 with a principal balance of \$6.0 million and accrued interest of \$865,000 (\$6.9 million total) is a shared appreciation credit, and as such, the Company agreed to receive interest on the loan as lots sold rather than monthly, and the borrower agreed to share in the profits of the project. Interest was accrued and recognized in income on an ongoing basis. Upon moving the credit to nonaccrual status during the first quarter of 2007, the Company ceased to accrue additional interest on the loan and continued to carry, on its books, the previously accrued interest amount of \$865,000, because it was supported by the most recent appraised value of the property at that time plus an added value for the recording of the approved map for the 177 lots which was imminent. Upon foreclosure and transfer to other real estate owned during the fourth quarter of 2007, the Company obtained an updated appraisal to determine the current fair value of the property. As a result of significant deterioration in the housing markets during this period, the Company adjusted the carrying value of the property down by \$2.4 million during the fourth quarter of 2007 with a charge against the allowance for credit losses.

Other real estate owned through foreclosure increased to \$6.7 million or 0.86% of total assets at December 31, 2007, as compared to \$1.9 million or 0.28% of total assets at December 31, 2006. During 2007, three properties with net collateral value totaling \$5.3 million were transferred from nonaccrual loans, one of which was subsequently sold during the year. The Company increased its focus on the resolution of impaired assets during the later part of 2007 and will continue to do so until nonperforming assets return to minimal levels.

A \$4.9 million loan classified as restructured at December 31, 2006, paid off during the first quarter of 2007, resulting in the recognition of approximately \$1.1 million in previously unrecognized interest income during 2007, and the overall reduction of restructured loans at December 31, 2007

Loans past due more than 30 days are receiving increased management attention and are monitored for increased risk. The Company continues to move past due loans to nonaccrual status in its ongoing effort to recognize loan problems

at an earlier point in time when they may be dealt with more effectively. As impaired loans, nonaccrual and restructured loans are reviewed for specific reserve allocations and the allowance for credit losses is adjusted accordingly.

Except for the loans included in the above table, and the land development loan discussed above, there were no loans at December 31, 2008 where the known credit problems of a borrower caused the Company to have serious doubts as to the ability of such borrower to comply with the present loan repayment terms and which would result in such loan being included as a nonaccrual, past due or restructured loan at some future date.

Liquidity and Asset/Liability Management

The primary function of asset/liability management is to provide adequate liquidity and maintain an appropriate balance between interest-sensitive assets and interest-sensitive liabilities.

Liquidity

Liquidity management may be described as the ability to maintain sufficient cash flows to fulfill both on- and off-balance sheet financial obligations, including loan funding commitments and customer deposit withdrawals, without straining the Company's equity structure. To maintain an adequate liquidity position, the Company relies on, in addition to cash and cash equivalents, cash inflows from deposits and short-term borrowings, repayments of principal on loans and investments, and interest income received. The Company's principal cash outflows are for loan origination, purchases of investment securities, depositor withdrawals and payment of operating expenses. Other sources of liquidity not on the balance sheet at December 31, 2008 include unused collateralized and uncollateralized lines of credit from other banks, the Federal Home Loan Bank, and from the Federal Reserve Bank totaling \$184.8 million.

Cash and cash equivalents have declined during the three years ended December 31, 2008, 2007, and 2006, with period-end balances as follows (from Consolidated Statements of Cash Flows – in 000's):

	Balance
December 31, 2008	\$ 19,426
December 31, 2007	\$ 25,300
December 31, 2006	\$ 43,068
December 31, 2005	\$ 63,030

Cash and cash equivalents decreased \$5.9 million during the year ended December 31, 2008, as compared to a decrease of \$17.8 million and \$20.0 million during the years ended December 31, 2007 and 2006, respectively.

The Company has maintained positive cash flows from operations over the past three years, which amounted to \$12.6 million, \$19.0 million, and \$16.2 million for the years ended December 31, 2008, 2007, and 2006, respectively.

The Company experienced net cash outflows from investing activities totaling \$9.4 million during the year ended December 31, 2008, as purchases of investment securities interest-bearing deposits in other banks exceeded net loan payoffs and maturities of investment securities during the period. The Company experienced net cash outflows from investing activities totaling \$30.5 million and \$69.8 million during the years ended December 31, 2007 and 2006, respectively, as loan growth has exceeded net maturities of investment securities as well as other investment instruments during those years.

Net cash flows from financing activities, including deposit growth and borrowings, have traditionally provided funding sources for loan growth, but during 2008 and 2007 the Company experienced net cash outflows totaling \$9.1 million and \$6.3 million, respectively, as declines in net deposit accounts, as well as repurchases of the Company's common stock, exceeded growth in financing categories, including borrowings. The Company has the ability to decrease loan growth, increase deposits and borrowings, or a combination of both to manage balance sheet liquidity.

Liquidity risk arises from the possibility the Company may not be able to satisfy current or future financial commitments, or the Company may become unduly reliant on alternative funding sources. The Company maintains a liquidity risk management policy to address and manage this risk. The policy identifies the primary sources of liquidity, establishes procedures for monitoring and measuring liquidity, and establishes minimum liquidity requirements, which comply with regulatory guidance. The liquidity position is continually monitored and reported on a monthly basis to the Board of Directors.

The policy also includes a contingency funding plan to address liquidity needs in the event of an institution-specific or a systemic financial market crisis. In addition to unused lines of credit from other banks totaling \$184.8 million, the contingency plan includes steps that may be taken in the event the total liquidity ratio falls or is projected to fall below

15% for any extended period of time. The Bank ALCO committee shall take steps to correct this condition using one or more of the following methods as needed:

- 1) Investments near maturity may be sold to meet temporary funding needs but may need to be replaced to maintain liquidity ratios within acceptable limits.
- 2) Unsecured Fed Funds lines with correspondents may be used to fund short-term peaks in loan demand or deposit run-off. Other off-balance sheet funding sources such as credit lines at FHLB or the FRB may be used for longer periods.

- 3) The Bank will not rely on brokered money as a primary source of funds. However, it may be prudent to utilize brokered deposits particularly at times when the interest costs are lower than could be obtained in the local market. However, the sum of all brokered deposits will not exceed 15% of the total deposits of the Bank.
- 4) The Bank may elect to operate a Telemarketing Money Desk for the purpose of acquiring Certificates of Deposits from both the local market and national market. The Board of Directors and management recognize that deposits acquired through money desk operations may be considered a higher cost and more volatile type of deposit than traditional bank deposits.
- 5) Selling whole loans or participation in loans or by increasing the amounts sold in existing participation loans are additional means for increasing liquidity.
- 6) The State of California Treasurer is a reliable source of deposits. The bank can typically accept CD's from this source up to 90% of equity as long as it has sufficient collateral pledged.
- 7) Marketing for CD's within our marketplace is another means for raising funds or through programs that post our rates on their Website, deposits from these sources should not exceed 15% of the bank's total deposits for extended periods beyond 90 days without board approval.
- 8) Should the Bank become illiquid in spite of these steps, it will curtail its lending activities. The first step in this process will be to curtail credit marketing and tighten pricing guidelines. The second step will be to encourage loan payoffs on a selective basis where circumstances and loan documentation provide this opportunity. Only as a last resort will the Bank totally curtail lending activities to credit worthy customers.

The Company continues to utilize liability management, when needed, as part of its overall asset/liability management strategy. Through the discretionary acquisition of short term borrowings, the Company has been able to provide liquidity to fund asset growth while, at the same time, better utilizing its capital resources, and better controlling interest rate risk. The borrowings are generally short-term and more closely match the repricing characteristics of floating rate loans, which comprise approximately 64.0% of the Company's loan portfolio at December 31, 2008. This does not preclude the Company from selling assets such as investment securities to fund liquidity needs but, with favorable borrowing rates, the Company has maintained a positive yield spread between borrowed liabilities and the assets which those liabilities fund. If, at some time, rate spreads become unfavorable, the Company has the ability to utilize an asset management approach and, either control asset growth or, fund further growth with maturities or sales of investment securities.

The Company's liquid asset base which generally consists of cash and due from banks, federal funds sold, securities purchased under agreements to resell ("reverse repos") and investment securities, is maintained at a level deemed sufficient to provide the cash outlay necessary to fund loan growth as well as any customer deposit runoff that may occur. Within this framework is the objective of maximizing the yield on earning assets. This is generally achieved by maintaining a high percentage of earning assets in loans, which historically have represented the Company's highest yielding asset. At December 31, 2008, the Bank had 70.1% of total assets in the loan portfolio and a loan-to-deposit ratio of 107.9%. Liquid assets at December 31, 2008 include cash and cash equivalents totaling \$19.4 million as compared to \$25.3 million at December 31, 2007.

Liabilities used to fund liquidity sources include core and non-core deposits as well as short-term borrowings. Core deposits, which comprise approximately 71.9% of total deposits at December 31, 2008, provide a significant and stable funding source for the Company. At December 31, 2008, unused lines of credit with the Federal Home Loan Bank and the Federal Reserve Bank totaling \$153.3 million are collateralized in part by certain qualifying loans in the Company's loan portfolio. The carrying value of loans pledged on these used and unused borrowing lines totaled \$327.5 million at December 31, 2008. For further discussion of the Company's borrowing lines, see "Short Term

Borrowings” included in previously in the financial condition section of this financial review.

Enacted during 2008 as part of the government’s Emergency Economic Stabilization Act, TARP (Treasury Asset Recovery Program) is a voluntary program established only for healthy financial institutions. In order to receive TARP capital, institutions must undergo an extensive review by their primary regulator and the U.S. Treasury Department. Along with high rates of interest, TARP capital comes with restrictions, including a U.S. Treasury Department right to buy shares (warrants) in the Company, and significant oversight requirements. At this time, the Company has not used TARP monies to increase capital.

The liquidity of the parent company, United Security Bancshares, is primarily dependent on the payment of cash dividends by its subsidiary, United Security Bank, subject to limitations imposed by the Financial Code of the State of California. During 2008 and 2007, total dividends paid by the Bank to the parent company totaled \$4.3 million and \$17.6 million, respectively. The Company currently believes the Bank has the ability in the future to pay sufficient cash dividends to the Company to cover its ongoing cash requirements including quarterly interest payments on its junior subordinated debt. As a bank holding company formed under the Bank Holding Act of 1956, United Security Bancshares continues to provide a source of financial strength for its subsidiary bank(s). To help provide financial strength to the Bank, United Security Bancshares' trust subsidiary, United Security Bancshares Capital Trust I completed a \$15 million offering in Trust Preferred Securities during 2001, the proceeds of which were used to purchase Junior Subordinated Debentures of the Company. Of the \$14.5 million in net proceeds received by the Company, \$13.7 million in cash was contributed as capital to United Security Bank enhancing the liquidity and capital positions of the Bank, and the remainder provided liquidity to the holding company. The Trust Preferred Securities issued under United Security Bancshares Capital Trust I were redeemed during July 2007, and subsequently, new Trust Preferred Securities totaling \$15 million were issued under United Security Bancshares Capital Trust II. The issuance of the new Trust Preferred Securities reduced the Company's cost of the debt by 246 basis points.

Contractual Obligations, Commitments, Contingent Liabilities, and Off-Balance Sheet Arrangements

The following table presents, as of December 31, 2008, the Company's significant fixed and determinable contractual obligations by payment date. The payment amounts represent those amounts contractually due to the recipient and do not include any unamortized premiums or discounts, or other similar carrying value adjustments. Further discussion of the nature of each obligation is included in the referenced note to the consolidated financial statements.

(In thousands)	Note Reference	One Year Or Less	Payments Due In			Total
			One to Three Years	Three to Five Years	Over Five Years	
Deposits without a stated maturity	7	\$ 323,727	\$ —	\$ —	\$ —	323,727
Time Deposits	7	172,730	11,230	788	11	184,759
FHLB Borrowings	8	77,500	11,000			88,500
Junior Subordinated Debt (at FV)	9, 10				11,926	11,926
Operating Leases	14	759	1,102	789	1,007	3,657
Contingent tax liabilities under FIN 48	11	1,473				1,473

A schedule of significant commitments at December 31, 2008 follows:

(In thousands)	
Commitments to extend credit:	
Commercial and industrial	\$ 60,676
Real estate – mortgage	53
Real estate – construction	30,502
Agricultural	16,597
Installment	3,638
Revolving home equity and credit card lines	814
Standby letters of credit	7,119

Further discussion of these commitments is included in Notes 3 and 14 to the consolidated financial statements.

Regulatory Matters

Capital Adequacy

Capital adequacy for bank holding companies and their subsidiary banks has become increasingly important in recent years. Continued deregulation of the banking industry since the 1980's has resulted in, among other things, a broadening of business activities allowed beyond that of traditional banking products and services. Because of this volatility within the banking and financial services industry, regulatory agencies have increased their focus upon ensuring that banking institutions meet certain capital requirements as a means of protecting depositors and investors against such volatility.

During July 2007, the Company redeemed its \$15.0 million in Trust Preferred Securities originally issued during 2001 under United Security Bancshares Capital Trust I. During the same month, the Company issued \$15.0 million in new Trust Preferred Securities with similar terms under newly formed United Security Bancshares Capital Trust II. Under applicable regulatory guidelines, the Trust Preferred Securities qualify as Tier 1 capital up to a maximum of 25% of Tier 1 capital. Any additional portion will qualify as Tier 2 capital. As shareholders' equity increases, the amount of Tier 1 capital that can be comprised of Trust Preferred Securities will increase.

The Board of Governors of the Federal Reserve System ("Board of Governors") has adopted regulations requiring insured institutions to maintain a minimum leverage ratio of Tier 1 capital (the sum of common stockholders' equity, noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, minus intangible assets, identified losses and investments in certain subsidiaries, plus unrealized losses or minus unrealized gains on available for sale securities) to total assets. Institutions which have received the highest composite regulatory rating and which are not experiencing or anticipating significant growth are required to maintain a minimum leverage capital ratio of 3% Tier 1 capital to total assets. To be considered well capitalized, the institution must maintain a leverage capital ratio of 5%. All other institutions are required to maintain a minimum leverage capital ratio of at least 100 to 200 basis points above the minimum requirements.

The Board of Governors has also adopted a statement of policy, supplementing its leverage capital ratio requirements, which provides definitions of qualifying total capital (consisting of Tier 1 capital and Tier 2 supplementary capital, including the allowance for loan losses up to a maximum of 1.25% of risk-weighted assets) and sets forth minimum risk-based capital ratios of capital to risk-weighted assets. The most highly rated insured institutions are required to maintain a minimum ratio of qualifying total capital to risk weighted assets of 8%, at least one-half (4%) of which must be in the form of Tier 1 capital. To be considered well capitalized, institutions must maintain a ratio of qualifying total capital to risk weighted assets of 10%, at least one-half (6%) of which must be in the form of Tier 1 capital.

The following table sets forth the Company's and the Bank's actual capital positions at December 31, 2008 and the regulatory minimums for the Company and the Bank to be well capitalized under the guidelines discussed above:

	Company Actual	Bank Actual	Regulatory Minimums - Well Capitalized
	Capital Ratios	Capital Ratios	Capital Ratios
Total risk-based capital ratio	13.23%	12.61%	10.00%
Tier 1 capital to risk-weighted assets	11.97%	11.45%	6.00%
Leverage ratio	10.58%	10.45%	5.00%

Under Federal Reserve guidelines, the Company and the Bank are required to maintain a total risk-based capital ratio of 10%, tier 1 capital to risk-weighted assets of 8%, and a leverage ratio of 7%, to be considered well capitalized. As is indicated by the above table, the Company and the Bank exceeded all applicable regulatory capital guidelines at December 31, 2008. Management believes that, under the current regulations, both will continue to meet their minimum capital requirements in the foreseeable future.

Dividends

Dividends paid to shareholders by the Company are subject to restrictions set forth in the California General Corporation Law. The California General Corporation Law provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal the amount of the proposed distribution. The primary source of funds with which dividends will be paid to shareholders will come from

cash dividends received by the Company from the Bank. During the year ended December 31, 2008, the Company received \$4.3 million in cash dividends from the Bank, from which the Company declared \$3.1 million in dividends to shareholders.

The Bank as a state-chartered bank is subject to dividend restrictions set forth in California state banking law, and administered by the California Commissioner of Financial Institutions (“Commissioner”). Under such restrictions, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank’s net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the Commissioner, in an amount not exceeding the Bank’s net income for its last fiscal year or the amount of its net income for the current fiscal year. Such restrictions do not apply to stock dividends, which generally require neither the satisfaction of any tests nor the approval of the Commissioner. Notwithstanding the foregoing, if the Commissioner finds that the shareholders’ equity is not adequate or that the declarations of a dividend would be unsafe or unsound, the Commissioner may order the state bank not to pay any dividend. The FRB may also limit dividends paid by the Bank. This is not the case with the Bank. Year-to-date dividends of \$4.3 million and \$4.6 million paid to shareholders and the Company, respectively, through December 31, 2008 were within the maximum allowed under those regulatory guidelines, and did not require prior approval of the Commissioner.

Stock Repurchase Plan (all figures have been restated to reflect effect of 2-for-1 stock split during May 2006)

	For the Quarters Ended				
	March 31,	June 30,	September 30,	December 31,	YTD
Shares repurchased – 2008	29,626	34,574	1,886	22,915	89,001
Average price paid – 2008	\$ 15.26	\$ 15.2	\$ 15.09	\$ 9.31	\$ 13.70
Shares repurchased – 2007	117,403	306,758	28,916	59,255	512,332
Average price paid – 2007	\$ 21.48	\$ 19.89	\$ 18.32	\$ 18.32	\$ 19.71
Shares repurchased – 2006	84	13,121	84,215	10,585	108,005
Average price paid - 2006	\$ 16.57	\$ 23.13	\$ 22.21	\$ 24.58	\$ 22.55
Shares repurchased - 2005	7,152	4,936	0	14,074	26,162
Average price paid - 2005	\$ 12.28	\$ 12.78	\$ —	\$ 16.16	\$ 14.46
Shares repurchased - 2004	19,800	109,490	45,986	3,564	178,840
Average price paid - 2004	\$ 12.85	\$ 11.41	\$ 11.29	\$ 12.11	\$ 11.55

On February 25, 2004 the Company announced a second stock repurchase plan under which the Board of Directors approved a plan to repurchase, as conditions warrant, up to 276,500 shares (553,000 shares adjusted for May 2006 stock split) of the Company's common stock on the open market or in privately negotiated transactions. As with the first stock repurchase plan initiated during 2001, the duration of the new program was open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Board terminated the 2001 repurchase plan and canceled the remaining 64,577 shares (129,154 shares adjusted for May 2006 stock split) yet to be purchased under the earlier plan.

On May 16, 2007, the Company announced another stock repurchase plan to repurchase, as conditions warrant, up to 610,000 shares of the Company's common stock on the open market or in privately negotiated transactions. The repurchase plan represents approximately 5.00% of the Company's currently outstanding common stock. The duration of the program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Company canceled the remaining 75,733 shares available under the 2004 repurchase plan.

During the year ended December 31, 2007, 512,332 shares were repurchased at a total cost of \$10.1 million and an average per share price of \$19.71. Of the shares repurchased during 2007, 166,660 shares were repurchased under the 2004 plan at an average cost of \$20.46 per shares, and 345,672 shares were repurchased under the 2007 plan at an average cost of \$19.35 per share.

During the year ended December 31, 2008, 89,001 shares were repurchased at a total cost of \$1.2 million and an average per share price of \$13.70

Reserve Balances

The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At December 31, 2008 the Bank's qualifying

balance with the Federal Reserve was approximately \$25,000.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Sensitivity and Market Risk

An interest rate-sensitive asset or liability is one that, within a defined time period, either matures or is subject to interest rate adjustments as market rates of interest change. Interest rate sensitivity is the measure of the volatility of earnings from movements in market rates of interest, which is generally reflected in interest rate spread. As interest rates change in the market place, yields earned on assets do not necessarily move in tandem with interest rates paid on liabilities. Interest rate sensitivity is related to liquidity in that each is affected by maturing assets and sources of funds. Interest rate sensitivity is also affected by assets and liabilities with interest rates that are subject to change prior to maturity.

The object of interest rate sensitivity management is to minimize the impact on earnings from interest rate changes in the marketplace. In recent years, deregulation, causing liabilities to become more interest rate sensitive, combined with interest rate volatility in the capital markets, has placed additional emphasis on this principal. When management decides to maintain repricing imbalances, it usually does so on the basis of a well- conceived strategy designed to ensure that the risk is not excessive and that liquidity is properly maintained. The Company's interest rate risk management is the responsibility of the Asset/Liability Management Committee (ALCO), which reports to the Board of Directors on a periodic basis, pursuant to established operating policies and procedures.

As part of its overall risk management, the Company pursues various asset and liability management strategies, which may include obtaining derivative financial instruments to mitigate the impact of interest fluctuations on the Company's net interest margin. During the second quarter of 2003, the Company entered into a five-year amortizing interest rate swap agreement with the purpose of minimizing interest rate fluctuations on its interest rate margin and equity. The interest rate swap agreement matured on September 30, 2008.

Under the interest rate swap agreement, the Company received a fixed rate and pays a variable rate based on the Prime Rate ("Prime"). The swap qualified as a cash flow hedge under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended, and was designated as a hedge of the variability of cash flows the Company receives from certain variable-rate loans indexed to Prime. In accordance with SFAS No. 133, the swap agreement was measured at fair value and reported as an asset or liability on the consolidated balance sheet. The portion of the change in the fair value of the swap that was deemed effective in hedging the cash flows of the designated assets were recorded in accumulated other comprehensive income and reclassified into interest income when such cash flow actually occurred. Any ineffectiveness resulting from the hedge was recorded as a gain or loss in the consolidated statement of income as part of noninterest income. The amortizing hedge had a remaining notional value of \$1.8 million and duration of approximately three months at December 31, 2007, and matured on September 30, 2008. During the years ended December 31, 2008 and 2007, \$5,000 and \$310,000, respectively, was reclassified from accumulated other comprehensive income as a reduction to interest income.

The Company performed a quarterly analysis of the effectiveness of the interest rate swap agreement at December 31, 2007 and for each of the quarters ended March 31, 2008 and June 30, 2008. As a result of a correlation analysis, the Company determined that the swap remained highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge and, therefore, continued to qualify for hedge accounting under the guidelines of SFAS No. 133. However, during the second quarter of 2006, the Company determined that the underlying loans being hedged were paying off faster than the notional value of the hedge instrument was amortizing. This difference between the notional value of the hedge and the underlying hedged assets is considered an "overhedge" pursuant to SFAS No. 133 guidelines and may constitute ineffectiveness if the difference is other than temporary. The Company determined during 2006 that the difference was other than temporary and, as a result, reclassified a net total of \$75,000 of the pretax hedge loss reported in other comprehensive income into earnings during 2006. As of December 31, 2007, the notional value of the hedge was still in excess of the value of the underlying loans being hedged by approximately \$1.3 million, but had improved from the \$3.3 million difference existing at December 31, 2006. As a result, the Company recorded a pretax hedge gain related to swap ineffectiveness of approximately \$66,000 during the December 31, 2007. With the interest rate swap maturing on September 30, 2008, the Company recognized the remaining hedge ineffectiveness gains of \$9,000 during 2008. Amounts recognized as hedge ineffectiveness gains or losses are reflected in noninterest income.

Interest rate risk can be measured through various methods including gap, duration and market value analysis as well as income simulation models, which provides a dynamic view of interest rate sensitivity based on the assumptions of the Company's Management. The Company employs each of these methods and refines these processes to make the most accurate measurements possible. The information provided by these calculations is the basis for management decisions in managing interest rate risk.

From the “Gap” report below, the Company is apparently subject to interest rate risk to the extent that its liabilities have the potential to reprice more quickly than its assets within the next year. At December 31, 2008, the Company had a cumulative 12-month Gap of \$20.7 million or 3.4% of total earning assets. Management believes the Gap analysis shown below is not entirely indicative of the Company’s actual interest rate sensitivity, because certain interest-sensitive liabilities would not reprice to the same degree as interest-sensitive assets. For example, if the prime rate were to change by 50 basis points, the floating rate loans included in the \$265.0 million immediately adjustable category would change by the full 50 basis points. Interest bearing checking and savings accounts which are also included in the immediately adjustable column probably would move only a portion of the 50 basis point rate change and, in fact, might not even move at all. The effects of market value risk have been mitigated to some degree by the makeup of the Bank's balance sheet. Loans are generally short-term or are floating-rate instruments. At December 31, 2008, \$457.8 million or 91.8% of the loan portfolio matures or reprices within one year, and less than 1.0% of the portfolio matures or reprices in more than 5 years.

Total investment securities including call options and prepayment assumptions, have a combined duration of approximately 1.7 years. More than \$505.4 million or 96.1% of interest-bearing liabilities mature or can be repriced within the next 12 months, even though the rate elasticity of deposits with no defined maturities may not necessarily be the same as interest-earning assets.

The following table sets forth the Company's gap, or estimated interest rate sensitivity profile based on ending balances as of December 31, 2008, representing the interval of time before earning assets and interest-bearing liabilities may respond to changes in market rates of interest. Assets and liabilities are categorized by remaining interest rate maturities rather than by principal maturities of obligations.

Maturities and Interest Rate Sensitivity

(In thousands)	December 31, 2008					Total
	Immediately	Next Day But Within Three Months	After Three Months Within 12 Months	After One Year But Within Five Years	After Five Years	
Interest Rate Sensitivity Gap:						
Loans (1)	\$ 264,978	\$ 116,868	\$ 75,909	\$ 39,193	\$ 1,932	\$ 498,880
Investment securities		25,131	23,413	37,947	6,258	92,749
Interest bearing deposits in other banks		16,500	3,336	595	0	20,431
Federal funds sold and reverse repos						0
Total earning assets	\$ 264,978	\$ 158,499	\$ 102,658	\$ 77,735	\$ 8,190	\$ 612,060
Interest-bearing transaction accounts	136,612					136,612
Savings accounts	37,586					37,586
Time deposits (2)	7,381	80,106	87,778	9,483	11	184,759
Federal funds purchased/other borrowings	66,545	77,500		11,000		155,045
Junior subordinated debt		11,926				11,926
Total interest-bearing liabilities	\$ 248,124	\$ 169,532	\$ 87,778	\$ 20,483	\$ 11	\$ 525,928
Interest rate sensitivity gap	\$ 16,854	\$ (11,033)	\$ 14,880	\$ 57,252	\$ 8,179	\$ 86,132
Cumulative gap	\$ 16,854	\$ 5,821	\$ 20,701	\$ 77,963	\$ 86,132	
Cumulative gap percentage to						

Total earning assets	2.8%	1.0%	3.4%	12.7%	14.1%
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(1) Loan balance does not include nonaccrual loans of \$51.906 million.

(2) See above for discussion of the impact of floating rate CD's.

The Company utilizes a vendor-purchased simulation model to analyze net interest income sensitivity to movements in interest rates. The simulation model projects net interest income based on a 100, 200, and 300 basis point rise and a 100, 200, and 300 basis point fall in interest rates ramped over a twelve-month period, with net interest impacts projected out as far as twenty-four months. In addition, a "most likely" scenario is projected based upon expected rate changes over the 24-month period. The model is based on the actual maturity and repricing characteristics of the Company's interest-sensitive assets and liabilities. The model incorporates assumptions regarding the impact of changing interest rates on the prepayment of certain assets and liabilities. Projected net interest income is calculated assuming customers will reinvest maturing deposit accounts and the Company will originate new loans. The balance sheet growth assumptions utilized correspond closely to the Company's strategic growth plans and annual budget. Excess cash is invested in overnight funds or other short-term investments such as U.S. Treasuries. Cash shortfalls are covered through additional borrowing of overnight or short-term funds. The Board of Directors has adopted an interest rate risk policy which establishes maximum decreases in net interest income of 12% and 15% in the event of a 100 BP and 200 BP increase or decrease in market interest rates over a twelve month period. Based on the information and assumptions utilized in the simulation model at December 31, 2008, the resultant projected impact on net interest income falls within policy limits set by the Board of Directors for all rate scenarios simulated.

The Company also utilizes the same vendor-purchased simulation model to project the impact of changes in interest rates on the underlying market value of all the Company's assets, liabilities, and off-balance sheet accounts under alternative interest rate scenarios. The resultant net value, as impacted under each projected interest rate scenario, is referred to as the market value of equity ("MV of Equity"). This technique captures the interest rate risk of the Company's business mix across all maturities. The market analysis is performed using an immediate rate shock of 100, 200, and 300 basis points up and down calculating the present value of expected cash flows under each rate environment at applicable discount rates. The market value of loans is calculated by discounting the expected future cash flows over either the term to maturity for fixed rate loans or scheduled repricing for floating rate loans using the current rate at which similar loans would be made to borrowers with similar credit ratings. The market value of investment securities is based on quoted market prices obtained from reliable independent brokers. The market value of time deposits is calculated by discounting the expected cash flows using current rates for similar instruments of comparable maturities. The market value of deposits with no defined maturities, including interest-bearing checking, money market and savings accounts is calculated by discounting the expected cash flows at a rate equal to the difference between the cost of these deposits and the alternate use of the funds, federal funds in this case. Assumed maturities for these deposits are estimated using decay analysis and are generally assumed to have implied maturities of less than five years. For noninterest sensitive assets and liabilities, the market value is equal to their carrying value amounts at the reporting date. The Company's interest rate risk policy establishes maximum decreases in the Company's market value of equity of 12% and 15% in the event of an immediate and sustained 100 BP and 200 BP increase or decrease in market interest rates. As shown in the table below, the percentage changes in the net market value of the Company's equity are within policy limits for both rising and falling rate scenarios.

The following sets forth the analysis of the Company's market value risk inherent in its interest-sensitive financial instruments as they relate to the entire balance sheet at December 31, 2008 and December 31, 2007 (\$ in thousands). Fair value estimates are subjective in nature and involve uncertainties and significant judgment and, therefore, cannot be determined with absolute precision. Assumptions have been made as to the appropriate discount rates, prepayment speeds, expected cash flows and other variables. Changes in these assumptions significantly affect the estimates and as such, the obtained fair value may not be indicative of the value negotiated in the actual sale or liquidation of such financial instruments, nor comparable to that reported by other financial institutions. In addition, fair value estimates are based on existing financial instruments without attempting to estimate future business.

Change in Rates	December 31, 2008			December 31, 2007		
	Estimated MV of Equity	Change in MV Of Equity \$	Change in MV Of Equity %	Estimated MV of Equity	Change in MV of Equity \$	Change in MV Of Equity %
+ 200 BP	\$ 78,206	\$ 2,935	3.90%	\$ 105,596	\$ 3,028	2.95%
+ 100 BP	77,483	2,212	2.94%	105,207	2,639	2.57%
0 BP	75,270	0	0.00%	102,568	0	0.00%
- 100 BP	76,528	1,258	1.67%	97,410	(5,158)	-5.03%
- 200 BP	78,732	3,462	4.60%	91,212	(11,356)	-11.07%

Item 8 - Financial Statements and Supplementary Data

Index to Consolidated Financial Statements:

Reports of Independent Registered Public Accounting Firm

Consolidated Balance Sheets - December 31, 2008 and 2007

Consolidated Statements of Income and Comprehensive Income -
Years Ended December 31, 2008, 2007 and 2006

Consolidated Statements of Shareholders' Equity -
Years Ended December 31, 2008, 2007 and 2006

Consolidated Statements of Cash Flows -
Years Ended December 31, 2008, 2007 and 2006

Notes to Consolidated Financial Statements

Moss Adams LLP
Certified Public Accountants

Report of Independent Registered Public Accounting Firm

To the Board of Directors
United Security Bancshares

We have audited the accompanying consolidated balance sheets of United Security Bancshares and Subsidiaries (Company) as of December 31, 2008 and 2007, and the related consolidated statements of income and comprehensive income, shareholders' equity and cash flows for each of the three years in the period ended December 31, 2008. These consolidated financial statements are the responsibility of Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of United Security Bancshares and Subsidiaries as of December 31, 2008 and 2007, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2008, in conformity with U.S. generally accepted accounting principles in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 16 2009 expressed an unqualified opinion thereon.

As discussed in Note 9 and 15 to the consolidated financial statements, effective January 1, 2007, the Company adopted the provisions of SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, and SFAS No. 157, Fair Value Measurements. As discussed in Note 11 to the consolidated financial statements, effective January 1, 2007, the Company adopted the provisions of FIN 48, Accounting for uncertainty in Income Taxes.

/s/ Moss Adams LLP

Stockton, California
March 16, 2009

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of
United Security Bancshares and Subsidiaries

We have audited United Security Bancshares and Subsidiaries (the Company) internal control over financial reporting as of December 31, 2008, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also includes performing such other procedures, as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, United Security Bancshares and Subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of United Security Bancshares and Subsidiaries as of December 31, 2008 and 2007, and the related consolidated statements of income and comprehensive income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2008, and our report dated March 16, 2009 expressed an unqualified opinion thereon.

/s/ Moss Adams LLP

Stockton, California

March 16, 2009

68

United Security Bancshares and Subsidiaries
Consolidated Balance Sheets
December 31, 2008 and 2007

(in thousands except shares)	December 31,	
	2008	2007
Assets		
Cash and due from banks	\$ 19,426	\$ 25,300
Federal funds sold	0	0
Cash and cash equivalents	19,426	25,300
Interest-bearing deposits in other banks	20,431	2,909
Investment securities available for sale (at fair value)	92,749	89,415
Loans and leases	549,976	598,220
Unearned fees	(1,234)	(1,739)
Allowance for credit losses	(15,071)	(10,901)
Net loans	533,671	585,580
Accrued interest receivable	2,394	3,658
Premises and equipment - net	14,285	15,574
Other real estate owned	30,153	6,666
Intangible assets	3,001	4,621
Goodwill	10,417	10,417
Cash surrender value of life insurance	14,460	13,852
Investment in limited partnerships	2,702	3,134
Deferred income taxes	7,138	4,301
Other assets	10,250	6,288
Total assets	\$ 761,077	\$ 771,715
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	\$ 149,529	\$ 139,066
Interest bearing	358,957	495,551
Total deposits	508,486	634,617
Federal funds purchased	66,545	10,380
Other borrowings	88,500	21,900
Accrued interest payable	648	1,903
Accounts payable and other liabilities	5,362	7,143
Junior subordinated debt (at fair value)	11,926	13,341
Total liabilities	681,467	689,284
Commitments and Contingent Liabilities		
Shareholders' Equity		
Common stock, no par value		
20,000,000 shares authorized, 12,010,372 and 11,855,192 issued and outstanding, in 2008 and 2007, respectively	34,811	32,587
Retained earnings	47,722	49,997
Accumulated other comprehensive loss	(2,923)	(153)
Total shareholders' equity	79,610	82,431
Total liabilities and shareholders' equity	\$ 761,077	\$ 771,715

See notes to consolidated financial statements

69

United Security Bancshares and Subsidiaries
Consolidated Statements of Income and Comprehensive Income
Years Ended December 31, 2008, 2007 and 2006

(in thousands except shares and EPS)	2008	2007	2006
Interest Income			
Loans, including fees	\$ 39,669	\$ 52,690	\$ 42,902
Investment securities - AFS – taxable	5,170	3,896	3,254
Investment securities - AFS – nontaxable	68	108	108
Federal funds sold and securities purchased under agreements to resell	18	191	768
Interest on deposits in other banks	222	271	324
Total interest income	45,147	57,156	47,356
Interest Expense			
Interest on deposits	12,088	18,414	12,597
Interest on other borrowed funds	2,850	2,159	1,578
Total interest expense	14,938	20,573	14,175
Net Interest Income Before			
Provision for Credit Losses	30,209	36,583	33,181
Provision for Credit Losses	9,598	5,697	880
Net Interest Income	20,611	30,886	32,301
Noninterest Income			
Customer service fees	4,656	4,790	3,779
Gain on disposition of securities	24	0	27
Gain on sale of other real estate owned	67	209	50
Gains from life insurance	0	483	482
Gain (loss) on interest swap ineffectiveness	9	66	(75)
Gain on sale of investment	0	0	1,877
Gain on fair value option of financial liability	1,363	2,504	0
(Loss) gain on sale of premises and equipment	(4)	2	1,018
Shared appreciation income	265	42	567
Other	1,963	1,568	1,306
Total noninterest income	8,343	9,664	9,031
Noninterest Expense			
Salaries and employee benefits	10,610	10,830	9,915
Occupancy expense	3,954	3,787	2,556
Data processing	279	420	470
Professional fees	1,482	1,811	998
Director fees	262	268	222
Amortization of intangibles	972	1,021	537
Correspondent bank service charges	427	476	204
Impairment loss on other investments	23	17	0
Impairment loss on OREO	887	0	0
Impairment loss on intangible assets	648	0	0
Loss on lease assets held for sale	0	820	0
Loss in equity of limited partnership	432	430	440
Expense on other real estate owned	418	209	2,193
Other	2,885	2,643	2,402
Total noninterest expense	23,279	22,732	19,937

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Income Before Provision for Taxes on Income	5,675	17,818	21,395
Provision for Taxes on Income	1,605	6,561	8,035
Net Income	\$ 4,070	\$ 11,257	\$ 13,360
Other comprehensive income, net of tax			
Unrealized income (loss) on available for sale securities, interest rate swaps, and unrecognized post-retirement costs - net income tax (benefit) expense of \$(1,845), \$758, and \$381, respectively	(2,770)	1,137	631
Comprehensive Income	\$ 1,300	\$ 12,394	\$ 13,991
Net Income per common share			
Basic	\$ 0.34	\$ 0.93	\$ 1.15
Diluted	\$ 0.34	\$ 0.92	\$ 1.14
Weighted shares on which net income per common share were based			
Basic	12,048,728	12,165,475	11,572,407
Diluted	12,052,150	12,200,920	11,692,705

See notes to consolidated financial statements

United Security Bancshares and Subsidiaries
Consolidated Statements of Changes in Shareholders' Equity
Years Ended December 31, 2008

(in thousands except shares)	Common stock Number of Shares	Amount	Accumulated		Total
			Retained Earnings	Other Comprehensive Income (Loss)	
Balance January 1, 2006	11,361,118	\$ 22,084	\$ 38,682	\$ (1,752)	\$ 59,014
Director/Employee stock options exercised	48,000	335			335
Tax benefit of stock options exercised		218			218
Net changes in unrealized gain on available for sale securities (net of income tax expense of \$242)				363	363
Net changes in unrealized gain on interest rate swaps (net of income tax expense of \$140)				268	268
Adjustment to initially apply SFAS No. 158 (net of income tax benefit of \$112)				(169)	(169)
Dividends on common stock (\$0.445 per share)			(5,158)		(5,158)
Repurchase and retirement of common shares	(108,005)	(2,437)			(2,437)
Stock-based compensation expense		248			248
Net Income			13,360		13,360
Balance December 31, 2006	11,301,113	20,448	46,884	(1,290)	66,042
Director/Employee stock options exercised	90,000	510			510
Net changes in unrealized gain on available for sale securities (net of income tax expense of \$605)				909	909
Net changes in unrealized gain on interest rate swaps (net of income tax expense of \$97)				145	145
Net changes in unrecognized past service Costs of employee benefit plans (net of income tax expense of \$55)				83	83
Dividends on common stock (\$0.50 per share)			(6,001)		(6,001)
Repurchase and retirement of common shares	(512,332)	(10,094)			(10,094)
	976,411	21,536			21,536

Issuance of shares for business combination						
Stock-based compensation expense		187				187
Cumulative effect of adoption of SFAS No. 159						
(net income tax benefit of \$613)			(845)			(845)
Cumulative effect of adoption of FIN48			(1,298)			(1,298)
Net Income			11,257			11,257
Balance December 31, 2007	11,855,192	\$	32,587	\$	49,997	\$ (153) \$ 82,431
Director/Employee stock options exercised	8,000		70			70
Net changes in unrealized gain on available for sale securities (net of income tax benefit of \$1,910)					(2,865)	(2,865)
Net changes in unrealized gain on interest rate swaps (net of income tax expense of \$1)					2	2
Net changes in unrecognized past service Costs of employee benefit plans (net of income tax expense of \$62)					93	93
Dividends on common stock (\$0.26 per share)					(3,081)	(3,081)
Common stock dividends	236,181		3,264		(3,264)	0
Repurchase and retirement of common shares	(89,001)		(1,220)			(1,220)
Stock-based compensation expense			110			110
Net Income			4,070			4,070
Balance December 31, 2008	12,010,372	\$	34,811	\$	47,722	\$ (2,923) \$ 79,610

See notes to consolidated financial statements

United Security Bancshares and Subsidiaries
Consolidated Statements of Cash Flows
Years December 31, 2008, 2007 and 2006

(in thousands)	2008	2007	2006
Cash Flows From Operating Activities:			
Net income	\$ 4,070	\$ 11,257	\$ 13,360
Adjustments to reconcile net income to cash provided by operating activities:			
Provision for credit losses	9,598	5,697	880
Depreciation and amortization	2,751	2,655	1,658
Accretion of investment securities	(123)	(95)	(70)
Gain on disposition of securities	(24)	0	(27)
Gain on sale of stock	0	0	(1,877)
Decrease (increase) in accrued interest receivable	1,263	930	(843)
(Decrease) increase in accrued interest payable	(1,255)	(339)	602
(Decrease) increase in unearned fees	(506)	509	246
Increase (decrease) in income taxes payable	413	150	(245)
Excess tax benefits from stock-based payment arrangements	0	0	(1)
Stock-based compensation expense	110	187	248
Deferred income taxes	(1,028)	248	(382)
(Increase) decrease in accounts payable and accrued liabilities	(427)	(130)	1,290
Impairment loss on other investments	23	17	0
Loss on lease assets held for sale	0	820	0
Gain on sale of other real estate owned	(67)	(209)	(50)
Impairment loss on other real estate owned	887	0	0
Impairment loss on intangible assets	648	0	0
(Gain) loss on swap ineffectiveness	(9)	(66)	75
Gain on fair value option of financial assets	(1,363)	(2,504)	0
Income from life insurance proceeds	0	(483)	(482)
Loss (gain) loss on sale of premises and equipment	4	(2)	(1,018)
(Increase) decrease in surrender value of life insurance	(608)	(184)	88
Loss in limited partnership interest	432	430	440
Net (increase) decrease in other assets	(2,204)	84	2,268
Net cash provided by operating activities	12,585	18,972	16,160
Cash Flows From Investing Activities:			
Net (increase) decrease in interest-bearing deposits with banks	(17,522)	4,984	(237)
Purchases of available-for-sale securities	(44,526)	(33,859)	0
Net (purchase) redemption of FHLB/FRB and other bank stock	(2,118)	103	51
Maturities, calls, and principal payments on available-for-sale securities	36,887	36,833	12,571
Investment in limited partnership	38	0	0
Investment in bank stock	(72)	(372)	0
Proceeds from sale of investment in title company	0	0	149
Premiums paid on life insurance	0	0	(227)
Net decrease (increase) in loans	16,526	(43,454)	(84,795)
Cash and equivalents received in bank acquisitions, net of assets and liabilities acquired	0	6,373	0
Cash proceeds from sale of correspondent bank stock	0	0	2,607
Cash proceeds from sales of foreclosed leased assets	56	39	1,946

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Cash proceeds from sales of other real estate owned	1,710	72	2,487
Capital expenditures for premises and equipment	(363)	(1,200)	(5,880)
Cash proceeds from sales of premises and equipment	0	9	1,520
Net cash used in investing activities	(9,384)	(30,472)	(69,808)
Cash Flows From Financing Activities:			
Net (decrease) increase in demand deposit and savings accounts	(9,068)	(99,787)	12,764
Net (decrease) increase in certificates of deposit	(117,063)	77,677	27,903
Net increase in federal funds purchased	56,165	22,280	0
Net increase in FHLB borrowings	66,600	10,000	0
Redemption of junior subordinated debt	0	(15,923)	0
Proceeds from issuance of junior subordinated debt	0	15,000	0
Director/Employee stock options exercised	70	510	335
Excess tax benefits from stock-based payment arrangements	0	0	1
Repurchase and retirement of common stock	(1,220)	(10,095)	(2,436)
Repayment of ESOP borrowings	0	0	0
Payment of dividends on common stock	(4,559)	(5,930)	(4,881)
Net cash (used in) provided by financing activities	(9,075)	(6,268)	33,686
Net decrease in cash and cash equivalents	(5,874)	(17,768)	(19,962)
Cash and cash equivalents at beginning of year	25,300	43,068	63,030
Cash and cash equivalents at end of year	\$ 19,426	\$ 25,300	\$ 43,068

See notes to consolidated statements

Notes to Consolidated Financial Statements
Years Ended December 31, 2008, 2007, and 2006

1. Organization and Summary of Significant Accounting and Reporting Policies

Basis of Presentation – The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary, United Security Bank and subsidiary (the “Bank”). United Security Bancshares Capital Trust II (the “Trust”) is deconsolidated pursuant to FIN46. As a result, the Trust’s Trust Preferred Securities are not presented on the Company’s consolidated financial statements, but instead the Company’s Subordinated Debentures are presented as a separate liability category. (see Note 10 to the Company’s consolidated financial statements). Intercompany accounts and transactions have been eliminated in consolidation. In the following notes, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares, (including the Bank and Trust). United Security Bancshares operates as one business segment providing banking services to commercial establishments and individuals primarily in the San Joaquin Valley of California.

Nature of Operations – United Security Bancshares is a bank holding company, incorporated in the state of California for the purpose of acquiring all the capital stock of the Bank through a holding company reorganization (the “Reorganization”) of the Bank. The Reorganization, which was accounted for in a manner similar to a pooling of interests, was completed on June 12, 2001. Management believes the Reorganization has provided the Company greater operating and financial flexibility and has permitted expansion into a broader range of financial services and other business activities.

United Security Bancshares Capital Trust I was formed during June 2001 as a Delaware statutory business trust for the exclusive purpose of issuing and selling Trust Preferred Securities. The Trust was deconsolidated in 2004 pursuant to FIN46. During July 2007, the Trust Preferred Securities were redeemed by USB Capital Trust I, and upon retirement, the Trust was dissolved. During July 2007 the Company formed United Security Bancshares Capital Trust II and issued \$15.0 million in Trust Preferred Securities with terms similar to those originally issued under USB Capital Trust I. (See Note 10. “Junior Subordinated Debt/Trust Preferred Securities”).

USB Investment Trust Inc was incorporated effective December 31, 2001 as a special purpose real estate investment trust (“REIT”) under Maryland law. The REIT is a subsidiary of the Bank and was funded with \$133.0 million in real estate-secured loans contributed by the Bank. USB Investment Trust was originally formed to give the Bank flexibility in raising capital, and reduce the expenses associated with holding the assets contributed to USB Investment Trust.

On February 16, 2007, the Company completed its merger with Legacy Bank, N.A., located in Campbell, California, with the acquisition of 100 percent of Legacy’s outstanding common shares. At merger, Legacy Bank’s one branch was merged with and into United Security Bank, a wholly owned subsidiary of the Company. The total value of the merger transaction was \$21.5 million, and the shareholders of Legacy Bank received merger consideration consisting of 976,411 shares of common stock of the Company. The merger transaction was accounted for as a purchase transaction, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities. The net of assets acquired and liabilities assumed totaled approximately \$8.6 million at the date of the merger. Fair value of Legacy assets and liabilities acquired, including resultant goodwill of approximately \$8.8 million. (See Note 25 to the Company’s consolidated financial statements contained herein for details of the merger).

During November 2007, the Company purchased the recurring revenue stream and certain fixed assets from ICG Financial, LLC. Additionally, the Company hired all but one of the former employees of ICG Financial, LLC and its subsidiaries. The total purchase price was \$414,000 including \$378,000 for the recurring revenue stream and \$36,000 for the fixed assets. ICG Financial, LLC provided wealth management, employee benefit, insurance and loan

products, as well as consulting services for a variety of clients. Now operating as a newly formed department of the Bank, USB Financial Services provides those same services utilizing the employees hired from ICG Financial LLC. The Company believes the wealth management and related services provided by USB Financial Services will enhance the products and services offered by the Company, and increase noninterest income. The capitalized cost of \$378,000 for the recurring revenue stream is being amortized over a period of approximately three years, and is tested periodically for impairment. During the fourth quarter of 2008, the Company reviewed the purchased revenue intangible for impairment and determined that the intangible asset was impaired. As a result the Company recorded an impairment loss of approximately \$24,000 during the fourth quarter, thus reducing carrying value the intangible asset.

The Bank was founded in 1987 and currently operates eleven branches and one construction lending office in an area from eastern Madera County to western Fresno County, as well as Taft and Bakersfield in Kern County, and Campbell in Santa Clara County. The Bank also operates one financial services department located in Fresno, California. The Bank's primary source of revenue is providing loans to customers, who are predominantly small and middle-market businesses and individuals. The Bank engages in a full compliment of lending activities, including real estate mortgage, commercial and industrial, real estate construction, agricultural and consumer loans, with particular emphasis on short and medium term obligations.

The Bank offers a wide range of deposit instruments. These include personal and business checking accounts and savings accounts, interest-bearing negotiable order of withdrawal ("NOW") accounts, money market accounts and time certificates of deposit. Most of the Bank's deposits are attracted from individuals and from small and medium-sized business-related sources.

The Bank also offers a wide range of specialized services designed to attract and service the needs of commercial customers and account holders. These services include cashiers checks, travelers checks, money orders, and foreign drafts. In addition, the Bank offers Internet banking services to its commercial and retail customers, and offers certain financial and wealth management services through its financial services department. The Bank does not operate a trust department, however it makes arrangements with its correspondent bank to offer trust services to its customers upon request.

Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change, relate to the determination of the allowance for loan losses, determination of goodwill, fair value of junior subordinated debt and certain collateralized mortgage obligations, and the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans. In connection with the determination of the allowance for loan losses and the valuation of foreclosed assets held for sale, management obtains independent appraisals for significant properties.

Significant Accounting Policies - The accounting and reporting policies of the Company conform to generally accepted accounting principles and to prevailing practices within the banking industry. The following is a summary of significant policies:

- a. Cash and cash equivalents – Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and repurchase agreements. At times throughout the year, balances can exceed FDIC insurance limits. Generally, federal funds sold and repurchase agreements are sold for one-day periods. Repurchase agreements are with a registered broker-dealer affiliated with a correspondent bank and work much like federal funds sold, except that the transaction is collateralized by various investment securities. The securities collateralizing such transactions generally consist of U.S. Treasuries, U.S. Government and U.S. Government-sponsored agencies. The Bank did not have any repurchase agreements during 2008 or 2007, or at December 31, 2008 or 2007. All cash and cash equivalents have maturities when purchased of three months or less.
- b. Securities - Debt and equity securities classified as available for sale are reported at fair value, with unrealized gains and losses excluded from net income and reported, net of tax, as a separate component of comprehensive income and shareholders' equity. Debt securities classified as held to maturity are carried at amortized cost. Gains and losses on disposition are reported using the specific identification method for the adjusted basis of the securities

sold.

The Company classifies its securities as available for sale or held to maturity, and periodically reviews its investment portfolio on an individual security basis. Securities that are to be held for indefinite periods of time (including, but not limited to, those that management intends to use as part of its asset/liability management strategy, those which may be sold in response to changes in interest rates, changes in prepayments or any such other factors) are classified as securities available for sale. Securities which the Company has the ability and intent to hold to maturity are classified as held to maturity.

Declines in fair value of individual held-to-maturity and available-for-sale securities below their cost that are other than temporary are recognized by write-downs of the individual securities to fair value. Such write-downs would be included in earnings as realized losses. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate investments, from rising interest rates. At each financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other-than-temporary based upon the positive and negative evidence available. Evidence evaluated includes, but is not limited to, industry analyst reports, credit market conditions, and interest rate trends. If negative evidence outweighs positive evidence that the carrying amount is recoverable within a reasonable period of time, the impairment is deemed to be other-than-temporary and the security is written down in the period in which such determination is made.

c. Loans - Interest income on loans is credited to income as earned and is calculated by using the simple interest method on the daily balance of the principal amounts outstanding. Loans are placed on non-accrual status when principal or interest is past due for 90 days and/or when management believes the collection of amounts due is doubtful. For loans placed on nonaccrual status, the accrued and unpaid interest receivable may be reversed at management's discretion based upon management's assessment of collectibility, and interest is thereafter credited to principal to the extent necessary to eliminate doubt as to the collectibility of the net carrying amount of the loan.

Nonrefundable fees and related direct costs associated with the origination or purchase of loans are deferred and netted against outstanding loan balances. The net deferred fees and costs are generally amortized into interest income over the loan term using the interest method. Other credit-related fees, such as standby letter of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or as a practical expedient at the loan's observable market rate or the fair value of the collateral if the loan is collateral dependent.

d. Allowance for Credit Losses and Reserve for Unfunded Loan Commitments - The allowance for credit losses is maintained to provide for losses that can reasonably be anticipated. The allowance is based on ongoing quarterly assessments of the probable losses inherent in the loan portfolio, and to a lesser extent, unfunded loan commitments. The reserve for unfunded loan commitments is a liability on the Company's consolidated financial statements and is included in other liabilities. The liability is computed using a methodology similar to that used to determine the allowance for credit losses, modified to take into account the probability of a drawdown on the commitment.

The allowance for credit losses is increased by provisions charged to operations during the current period and reduced by loan charge-offs net of recoveries. Loans are charged against the allowance when management believes that the collection of the principal is unlikely. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing loans, based on evaluations of the probability of collection. In evaluating the probability of collection, management is required to make estimates and assumptions that affect the reported amounts of loans, allowance for credit losses and the provision for credit losses charged to operations. Actual results could differ significantly from those estimates. These evaluations take into consideration such factors as the composition of the portfolio, overall portfolio quality, loan concentrations, specific problem loans, and current economic conditions that may affect the borrowers' ability to pay. The Company's methodology for assessing the adequacy of the allowance for credit losses consists of several key elements, which include the formula allowance, specific allowances, and the unallocated allowance.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unfunded loan commitments. Loss factors are based on the Company's historical loss experience and may be adjusted for significant factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date. The Company determines the loss factors for problem-graded loans (substandard, doubtful, and loss), special mention loans, and pass graded loans, based on a loss migration model. The migration analysis incorporates the Company's losses over the past twelve quarters (three years) and loss factors are adjusted to recognize and quantify the loss exposure from changes in market conditions and trends in the loan portfolio. For purposes of this analysis, loans are grouped by internal risk classifications, which are "pass", "special mention", "substandard", "doubtful", and "loss". Certain loans are homogenous in nature and are therefore pooled by risk grade. These homogenous loans include consumer installment and home equity loans. Special mention loans are currently performing but are potentially weak, as the borrower has begun to exhibit deteriorating trends, which if not corrected, could jeopardize repayment of the loan and result in further downgrade. Substandard loans have well-defined weaknesses which, if not corrected, could jeopardize the full satisfaction of the debt. A loan classified as "doubtful" has critical weaknesses that make full collection of the obligation improbable. Classified loans, as defined by the Company, include loans categorized as substandard,

doubtful, and loss.

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in classified loans, impaired loans, and other loans in which management believes it is probable that a loss has been incurred in excess of the amount determined by the application of the formula allowance.

75

The unallocated portion of the allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentration, and other business conditions.

The allowance analysis also incorporates the results of measuring impaired loans as provided in Statement of Financial Accounting Standards ("SFAS") No. 114, "Accounting by Creditors for Impairment of a Loan" and SFAS 118, "Accounting by Creditors for Impairment of a Loan - Income Recognition and Disclosures". A loan is considered impaired when management determines that it is probable that the Company will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Impairment is measured by the difference between the original recorded investment in the loan and the estimated present value of the total expected cash flows, discounted at the loan's effective rate, or the fair value of the collateral, if the loan is collateral dependent. Any differences in the specific allowance amounts calculated in the impaired loan analysis and the migration analysis are reconciled by management and changes are made to the allowance as deemed necessary.

e. Loans held-for-sale - Loans originated and designated as held-for-sale are carried at the lower of cost or estimated fair value, as determined by quoted market prices, in aggregate. Net unrealized losses are recognized in a valuation allowance by charges to income. Gains or losses on the sale of such loans are based on the specific identification method. The Company held no loans for sale at December 31, 2008 or 2007.

f. Premises and Equipment - Premises and equipment are carried at cost less accumulated depreciation. Depreciation expense is computed principally on the straight-line method over the estimated useful lives of the assets. Estimated useful lives are as follows:

Buildings 31 Years	Furniture and equipment	3-7 Years
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g. Other Real Estate Owned - Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for credit losses. Subsequent declines in the fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense at foreclosure.

h. Intangible Assets and Goodwill - Intangible assets are comprised of core deposit intangibles, other specific identifiable intangibles, and goodwill acquired in branch acquisitions in which the fair value of the liabilities assumed exceeded the fair value of the assets acquired. Intangible assets and goodwill are reviewed at least annually for impairment. Core deposit intangibles of \$2,278,000 and \$3,611,000 (net of accumulated amortization and impairment losses of \$4,719,000 and accumulated amortization of \$3,386,000) at December 31, 2008 and 2007 are amortized over the estimated useful lives of the existing deposit bases (average of 7 years) using a method which approximates the interest method. Other specific identifiable intangibles resulting from the purchase of certain bank branches during 1997, which were non self-sustaining businesses, of \$517,000 and \$653,000 (net accumulated amortization of \$1.4 million and \$1.3 million) at December 31, 2008 and 2007 are being amortized using a method which approximates the interest method over a period of 15 years. The identifiable intangible asset resulting from the purchase of the recurring income stream from ICG Financial Services totaled \$206,000 at December 31, 2008 (net accumulated amortization of \$147,000 and impairment losses of \$24,000) and is being amortized over a period of three years.

During the first quarter of 2008, the Company recognized an impairment loss of \$623,000 on the core deposit intangible related to the deposits purchased in the Legacy merger consummated during February 2007. During the fourth quarter of 2008, the Company recognized an additional impairment loss of \$24,000 on the identifiable intangible asset related to the purchased revenue of ICG Financial Services.

The estimated aggregate amortization expense related to intangible assets for each of the five succeeding years is as follows (in 000's):

Year	Amortization expense
2009	\$ 749
2010	657
2011	481
2012	349
2013	187
Total	\$ 2,423

Goodwill amounts resulting from the acquisitions of Taft National Bank during April 2004, and Legacy Bank during February 2007 are considered to have an indefinite life and are not amortized. At December 31, 2008 goodwill related to Taft National Bank totaled \$1.6 million, and goodwill related to Legacy Bank totaled \$8.8 million. Pursuant to SFAS No. 142, Goodwill and Other Intangible Assets, goodwill is evaluated annually for impairment. Impairment testing of goodwill is performed during April of each year at a reporting unit level for Taft, and will be performed during March of each year for Legacy. The Company had no impairment adjustments related to goodwill during 2008, 2007, or 2006.

- i. **Income Taxes** - Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities using the liability method, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled.
- j. **Net Income per Share** - Basic income per common share is computed based on the weighted average number of common shares outstanding. Diluted income per share includes the effect of stock options and other potentially dilutive securities using the treasury stock method.
- k. **Cash Flow Reporting** - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing amounts due from banks, federal funds sold and securities purchased under agreements to resell. Federal funds and securities purchased under agreements to resell are generally sold for one-day periods.
- l. **Transfers of Financial Assets** - Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.
- m. **Advertising Costs** - The Company expenses marketing costs as they are incurred. Advertising expense was \$121,000, \$113,000, and \$105,000 for the years ended December 31, 2008, 2007 and 2006, respectively.
- n. **Stock Based Compensation** - At December 31, 2008, the Company has a stock-based employee compensation plan, which is described more fully in Note 12. The Company accounts for the stock-based employee compensation plan pursuant to the provisions of Financial Accounting Standards Board (FASB) Statement No. 123 R, "Accounting for Share-Based Payments". SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on the grant-date fair value of the award. The fair value is amortized over the requisite service period (generally the vesting period). Included in salaries and employee benefits for the years ended December 31, 2008, 2007 and 2006 is \$110,000, \$187,000 and \$248,000, respectively, of share-based compensation. The related tax benefit, recorded in the provision for income taxes, was not significant.
- o. **Long-Lived Assets** - The Company periodically evaluates the carrying value of long-lived assets to be held and used, including other specific intangible assets, and core deposit intangible assets in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." Based on such evaluation, the Company recognized impairment losses of \$623,000 and \$24,000 on core deposits intangible assets and the identifiable intangible asset related to the purchased revenue of ICG Financial Services, respectively, during 2008. The Company determined that there was no impairment of long-lived assets 2007 or 2006.
- p. **Derivative Financial Instruments** - All derivative instruments (including certain derivative instruments embedded in other contracts) are recognized in the consolidated balance sheet at fair value. The Company's accounting treatment for gains or losses from changes in the derivative instrument's fair value is contingent on whether the derivative

instrument qualifies as a hedge. On the date the Company enters into a derivative contract, the Company designates the derivative instruments as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge) or (3), a hedge for trading, customer accommodation or not qualifying for hedge accounting (free-standing derivative instruments). For a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability or of an unrecognized firm commitment attributable to the hedged risk are recorded in current period net income. For a cash flow hedge, changes in the fair value of the derivative instrument to the extent that it is highly effective are recorded in other comprehensive income, net of tax, within shareholders' equity and subsequently reclassified to net income in the same period(s) that the hedged transaction impacts net income. For freestanding derivative instruments, changes in the fair values are reported in current period net income. The Company formally documents the relationship between hedging instruments and hedged items, as well as the risk management objective and strategy for undertaking any hedge transaction. This process includes relating all derivative instruments that are designated as fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific forecasted transactions. The Company also formally assesses both at the inception of the hedge and on an ongoing basis, whether the derivative instruments used are highly effective in offsetting changes in fair values or cash flows of hedged items. If it is determined that the derivative instrument is not, and will not be, highly effective as a hedge, hedge accounting is discontinued.

- q. Federal Home Loan Bank stock and Federal Reserve Stock - As a member of the Federal Home Loan Bank (FHLB), the Company is required to maintain an investment in capital stock of the FHLB. In addition, as a member of the Federal Reserve Bank (FRB), the Company is required to maintain an investment in capital stock of the FRB. The investments in both the FHLB and the FRB are carried at cost in the accompanying consolidated balance sheets under other assets and are subject to certain redemption requirements by the FHLB and FRB.
- r. Comprehensive Income -Comprehensive income is comprised of net income and other comprehensive income. Other comprehensive income includes items previously recorded directly to equity, such as unrealized gains and losses on securities available-for-sale, unrecognized costs of salary continuation defined benefit plans, and certain derivative instruments used as a cash flow hedge. Comprehensive income is presented in the consolidated statement of shareholders' equity.
- s. Segment Reporting - The Company's operations are solely in the financial services industry and include providing to its customers traditional banking and other financial services. The Company operates primarily in the San Joaquin Valley region of California. Management makes operating decisions and assesses performance based on an ongoing review of the Company's consolidated financial results. Therefore, the Company has a single operating segment for financial reporting purposes.

t.

New Accounting Standards:

Statements of Financial Accounting Standards

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements," which provides guidance for accounting and reporting of noncontrolling (minority) interests in consolidated financial statements. The statement is effective for fiscal years and interim periods within fiscal years beginning on or after December 15, 2008. The Company does not hold minority interests in subsidiaries, therefore it is expected that SFAS No. 160 will have no impact on its financial condition or results of operations.

In February 2007, the FASB issued SFAS 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115. SFAS 159 allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. SFAS 159 also requires entities to report those financial assets and financial liabilities measured at fair value in a manner that separates those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute on the face of the statement of financial position. Lastly, SFAS 159 establishes presentation and disclosure requirements designed to improve comparability between entities that elect different measurement attributes for similar assets and liabilities. SFAS 159 is effective for fiscal years beginning after November 15, 2007, with early adoption permitted if an entity also early adopts the provisions of SFAS 157. Effective January 1, 2007, the Company elected early adoption of the fair value option to value its junior subordinated debt. The initial impact upon adoption of SFAS No. 159 was to record a \$1.3 million loss, reflected as an adjustment to beginning retained earnings at January 1, 2007. Subsequent to adoption, the Company recorded total gains resulting from fair value adjustments on its junior subordinated debt totaling \$2.5 million during the year ended December 31, 2007, which are reflected as a component of other noninterest income. (see Note 9).

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans ("SFAS No. 158"). SFAS No. 158 amends SFAS No. 87 and SFAS No. 106. SFAS No. 158 amends previous applicable accounting statements and requires companies to better disclose, among other things, the funded status of benefit plans, and to recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, Employers'

Accounting for Pensions, or No. 106, Employers' Accounting for Postretirement Benefits Other Than Pensions. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements. SFAS No. 158 is effective for public companies with fiscal years ending after December 15, 2006. The Company adopted SFAS No. 158 effective December 31, 2006, and has made required disclosures since December 31, 2006. As a result, the Company upon adoption at December 31, 2006, recorded \$169,000 in accumulated other comprehensive income (net tax of \$112,000) for the previously unrecognized cost of post-retirement benefits related to the Company's Salary Continuation Plan, and had \$8,000 in other comprehensive income (net tax of \$5,000) for the excess net periodic benefit costs at December 31, 2008 (see Note 13, Employee Benefit Plans).

In September 2006, the FASB issued SFAS 157, Fair Value Measurements. SFAS No. 157 clarifies the definition of fair value, describes methods used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. This statement applies whenever other accounting pronouncements require or permit fair value measurements and is effective for fiscal years beginning after November 15, 2007. Effective January 1, 2007, the Company adopted SFAS No. 157 as a result of its early adoption of SFAS No. 159 (see Note 15).

In March 2008, the Financial Accounting Standards Board (FASB) issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an Amendment of FASB Statement 133." SFAS No. 161 enhances required disclosures regarding derivatives and hedging activities, including enhanced disclosures regarding how an entity uses derivative instruments and how derivative instruments and related hedged items are accounted for and affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Adoption of SFAS No. 161 as of January 1, 2009 has not had a material impact on the Company's consolidated financial position or results of operations, as it impacts financial statement disclosure only.

Financial Accounting Standards Board Staff Positions and Interpretations

On July 13, 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation 48 (FIN 48), Accounting for Uncertainty in Income Taxes: an interpretation of FASB Statement No. 109. FIN 48 clarifies SFAS No. 109, Accounting for Income Taxes, to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity's financial statements. Under the guidelines of the Interpretation, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term "more likely than not" means "a likelihood of more than 50 percent." In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority. The scope of FIN 48 is broad and includes all tax positions accounted for in accordance with SFAS No. 109. Additionally, besides business enterprises, FIN 48 applies to pass-through entities, and entities whose tax liability is subject to 100 percent credit for dividends paid (such as real estate investment trusts). FIN 48 is effective for the Company beginning after January 1, 2007. The cumulative effect of applying FIN 48 totaling \$1.3 million was reported as an adjustment to retained earnings at January 1, 2007 (see Note 11).

In September 2006, the Emerging Issues Task Force (EITF) reached a final consensus on Issue No. 06-4 (EITF 06-4), "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." EITF 06-4 requires employers to recognize a liability for future benefits provided through endorsement split-dollar life insurance arrangements that extend into postretirement periods in accordance with SFAS No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions or APB Opinion No. 12, Omnibus Opinion-1967." The provisions of EITF 06-4 become effective on January 1, 2008 and are to be applied as a change in accounting principle either through a cumulative-effect adjustment to retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption, or through retrospective application to all prior periods. The Company's split-dollar life insurance benefits are limited to the employee's active service period. Therefore EITF 06-4 did not have a significant impact on the Company's financial condition or results of operations.

FASB Staff Position (FSP) No. 157-2. FSP 157-2 delays the effective date of SFAS 157, Fair Value Measurements, for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the FASB and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of SFAS 157. This FSP defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years for items within the scope of this FSP. FSP 157-2 was effective for

the Company on January 1, 2009 and did not have a significant impact on the Company's financial statements.

FASB Staff Position No. 157-3. On October 10, 2008, the FASB issued FASB Staff Position 157- 3 (“FSP 157-3”) Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active. FSP 157-3 applies to financial assets within the scope of SFAS 157. FSP 157-3 clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. In situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an exit price notion) that is not a forced liquidation or distressed sale at the measurement date. Additionally, in determining fair value for a financial asset, the use of a reporting entity’s own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. FSP 157-3 was effective for the Company on September 30, 2008. Although FSP 157-3 did not have a significant impact on the Company’s financial statements at December 31, 2008, it did provide additional guidance used in the Company’s evaluation of fair value at December 31, 2008.

On January 12, 2009, the FASB staff issued FASB Staff Position (FSP) EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20, which eliminated the reference to the “market participant” view of expected cash flows when making impairment determinations for certain beneficial interests in securitized financial instruments. The guidance is intended to reduce complexity and achieve a more consistent determination of whether other-than-temporary impairments of available-for-sale and held-to-maturity debt securities have occurred by aligning the impairment guidance for certain beneficial interests with the impairment guidance for other debt securities. FSP 99-20-1 was effective for the Company for reporting periods ending after December 15, 2008. The Company adopted FSP 99-20-1 effective December 31, 2008 and utilized the revised method, the effects of which are included in the Company’s financial statements at December 31, 2008.

v. Reclassifications - Certain reclassifications have been made to the 2007 and 2006 financial statements to conform to the classifications used in 2008.

2. Investment Securities

Following is a comparison of the amortized cost and approximate fair value of investment securities for the years ended December 31, 2008 and December 31, 2007:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
December 31, 2008:				
Securities available for sale:				
U.S. Government agencies	\$ 43,110	\$ 1,280	\$ (204)	\$ 44,186
Collateralized mortgage obligations	39,068	189	(4,991)	34,266
Obligations of state and political subdivisions	1,252	28	0	1,280
Other investment securities	13,880	0	(863)	13,017
Total securities available for sale	\$ 97,310	\$ 1,497	\$ (6,058)	\$ 92,749
December 31, 2007:				
Securities available for sale:				
U.S. Government agencies	\$ 65,764	\$ 524	\$ (302)	\$ 65,986
Collateralized mortgage obligations	7,782	44	(4)	7,822
	2,227	54	0	2,281

Obligations of state and political
subdivisions

Other investment securities	13,752	0	(426)	13,326
Total securities available for sale	\$ 89,525	\$ 622	\$ (732)	\$ 89,415

Included in other investment securities at December 31, 2008, is a short-term government securities mutual fund totaling \$7.2 million, a CRA-qualified mortgage fund totaling \$4.9 million, and an overnight money-market mutual fund totaling \$880,000. Included in other investment securities at December 31, 2007, is a short-term government securities mutual fund totaling \$7.7 million, a CRA-qualified mortgage fund totaling \$4.9 million, and an overnight money-market mutual fund totaling \$752,000. The commercial asset-backed trust consists of fixed and floating rate commercial and multifamily mortgage loans. The short-term government securities mutual fund invests in debt securities issued or guaranteed by the U.S. Government, its agencies or instrumentalities, with a maximum duration equal to that of a 3-year U.S. Treasury Note.

Management periodically evaluates each available-for-sale investment security in an unrealized loss position to determine if the impairment is temporary or other-than-temporary. Management has determined that no investment security is other than temporarily impaired. The unrealized losses are due in most part to interest rate changes, as well as credit downgrades in some of the portfolio including three collateralized mortgage obligations. The Company has the ability and intent to hold all investment securities with identified impairments resulting from interest rate changes and credit downgrades to the earlier of the forecasted recovery or the maturity of the underlying investment security. The Company believes that credit downgrades on securities within the portfolio are a result of the severity of the current economic downturn and does not believe the downgrades will result in other-than-temporary impairment of those securities.

The following summarizes temporarily impaired investment securities at December 31, 2008 and 2007:

(In thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
December 31, 2008:						
Securities available for sale:						
U.S. Government agencies	\$ 6,471	\$ (204)	\$ 0	\$ 0	\$ 6,471	\$ (204)
Collateralized mortgage obligations	17,568	(4,991)	0	0	17,568	(4,991)
Obligations of state and political subdivisions	0	0	0	0	0	0
Other investment securities	0	0	12,137	(863)	12,137	(863)
Total impaired securities	\$ 24,039	\$ (5,195)	\$ 12,137	\$ (863)	\$ 36,176	\$ (6,058)
December 31, 2007:						
Securities available for sale:						
U.S. Government agencies	\$ 0	\$ 0	\$ 30,241	\$ (302)	\$ 30,241	\$ (302)
Collateralized mortgage obligations	4,129	(4)	0	0	4,129	(4)
Obligations of state and political subdivisions	0	0	0	0	0	0
Other investment securities	0	0	12,574	(426)	12,574	(426)
Total impaired securities	\$ 4,129	\$ (4)	\$ 42,815	\$ (728)	\$ 46,944	\$ (732)

Temporarily impaired securities at December 31, 2008 are comprised of four (4) collateralized mortgage obligations, seven (7) U.S. government agency securities, and two (2) other investment securities, with a total weighted average life of 3.1 years.

Temporarily impaired securities at December 31, 2007 are comprised of nine (9) U.S. government agency securities, one U.S. agency collateralized mortgage obligation, and two other investment securities, with a total weighted average life of 1.0 years.

There were gross realized gains on sales of available-for-sale securities totaling \$24,000, and \$27,000 during the years ended December 31, 2008, and 2006, respectively. There were no gross realized gains or losses on available-for-sale securities during the year ended December 31, 2007. There were no gross realized losses on available-for-sale securities during the year ended December 31, 2008 or 2006.

The amortized cost and fair value of securities available for sale at December 31, 2008, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns.

(In thousands)	December 31, 2008	
	Amortized Cost	Fair Value (Carrying Amount)
Due in one year or less	\$ 14,577	\$ 13,717
Due after one year through five years	3,866	3,994
Due after five years through ten years	9,148	9,529
Due after ten years	30,652	31,243
Collateralized mortgage obligations	39,067	34,266
	\$ 97,310	\$ 92,749

At December 31, 2008 and 2007, available-for-sale securities with an amortized cost of approximately \$81.4 million and \$71.0 million (fair value of \$79.6 million and \$71.3 million) were pledged as collateral for public funds, treasury tax and loan balances, and repurchase agreements.

The Company had no held-to-maturity or trading securities at December 31, 2008 or 2007.

3. Loans

Loans are comprised of the following:

(In thousands)	December 31,	
	2008	2007
Commercial and industrial	\$ 223,581	\$ 204,385
Real estate – mortgage	126,689	142,565
Real estate – construction	119,884	178,296
Agricultural	52,020	46,055
Installment	20,782	18,171
Lease financing	7,020	8,748
Total Loans	\$ 549,976	\$ 598,220

The Company's loans are predominantly in the San Joaquin Valley, and the greater Oakhurst/East Madera County area, as well as the Campbell area of Santa Clara County, although the Company does participate in loans with other financial institutions, primarily in the state of California.

Commercial and industrial loans represent 40.7% of total loans at December 31, 2008 and have a high degree of industry diversification. A substantial portion of the commercial and industrial loans are secured by accounts receivable, inventory, leases or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 23.0% of total loans at December 31, 2008, are secured by trust deeds on primarily commercial property. Repayment of real estate mortgage loans is generally from the cash flow of the borrower.

Real estate construction loans, representing 21.7% of total loans at December 31, 2008, consist of loans to residential contractors, which are secured by single-family residential properties. All real estate loans have established equity requirements. Repayment on construction loans is generally from long-term mortgages with other lending institutions.

Agricultural loans represent 9.5% of total loans at December 31, 2008 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Lease financing loans, representing 1.3% of total loans at December 31, 2008, consist of loans to small businesses, which are secured by commercial equipment. Repayment of the lease obligation is from the cash flow of the borrower.

Occasionally, shared appreciation agreements are made between the Company and the borrower on certain construction loans where the Company agrees to receive interest on the loan at maturity rather than monthly and the borrower agrees to share in the profits of the project. Due to the difficulty in calculating future values, shared appreciation income is recognized when received. The Company does not participate in a significant number of shared appreciation projects. Shared appreciation income totaled \$265,000, \$42,000, and \$567,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

Loans over 90 days past due and still accruing totaled \$680,000 and \$189,000 at December 31, 2008 and December 31, 2007, respectively. Nonaccrual loans totaled \$51.1 million and \$21.6 million at December 31, 2008 and 2007, respectively. There were remaining undisbursed commitments to extend credit on nonaccrual loans of \$1.6 million and \$12,000 at December 31, 2008 and December 31, 2007, respectively. The interest income that would have been earned on nonaccrual loans outstanding at December 31, 2008 in accordance with their original terms is approximately \$3.7 million. There was no interest income recorded on such loans during the year ended December 31, 2008 and 2007. The interest income recorded on such loans during 2006 totaled \$65,000.

The Company has, and expects to have, lending transactions in the ordinary course of its business with directors, officers, principal shareholders and their affiliates. These loans are granted on substantially the same terms, including interest rates and collateral, as those prevailing on comparable transactions with unrelated parties, and do not involve more than the normal risk of collectibility or present unfavorable features.

Loans to directors, officers, principal shareholders and their affiliates are summarized below:

(In thousands)	December 31,	
	2008	2007
Aggregate amount outstanding, beginning of year	\$ 7,436	\$ 1,605
New loans or advances during year	13,667	9,734
Repayments during year	(3,242)	(3,903)
Aggregate amount outstanding, end of year	\$ 17,861	\$ 7,436
Loan commitments	\$ 8,380	\$ 6,799

An analysis of changes in the allowance for credit losses is as follows:

(In thousands)	Years Ended December 31,		
	2008	2007	2006
Balance, beginning of year	\$ 10,901	\$ 8,365	\$ 7,748
Provision charged to operations	9,598	5,697	880
Losses charged to allowance	(5,545)	(4,493)	(502)
Recoveries on loans previously charged off	117	64	239
Reserve acquired in merger	0	1,268	—
Balance at end-of-period	\$ 15,071	\$ 10,901	\$ 8,365

The allowance for credit losses represents management's estimate of the risk inherent in the loan portfolio based on the current economic conditions, collateral values and economic prospects of the borrowers. Significant changes in these estimates might be required in the event of a downturn in the economy and/or the real estate markets in the San Joaquin Valley, the greater Oakhurst and East Madera County area, and in Santa Clara County.

At December 31, 2008 and 2007, the Company's recorded investment in loans for which impairment has been recognized totaled \$54.4 million and \$20.6 million, respectively. Included in total impaired loans at December 31, 2008 are \$31.0 million of impaired loans for which the related specific allowance is \$8.5 million, as well as \$23.4 million of impaired loans that as a result of write-downs or the fair value of the collateral, did not have a specific allowance. At December 31, 2007, total impaired loans included \$10.7 million for which the related specific allowance is \$4.5 million, as well as \$9.9 million of impaired loans that as a result of write-downs to the fair value of the collateral did not have a specific allowance. The average recorded investment in impaired loans was \$37.1 million, \$15.9 million, and \$10.1 million for the years ended December 31, 2008, 2007, and 2006, respectively. In most cases, the Company uses the cash basis method of income recognition for impaired loans. In the case of certain troubled debt restructuring for which the loan is performing under the current contractual terms for a reasonable period of time,

income is recognized under the accrual method. For the year ended December 31, 2008 and 2007, the Company recognized no income on impaired loans. For the year ended December 31, 2006, the Company recognized income of \$65,000 on such loans.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At December 31, 2008 and 2007 these financial instruments include commitments to extend credit of \$112.3 million and \$196.3 million, respectively, and standby letters of credit of \$7.1 million and \$6.7 million, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the counterparty to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The Company uses the same credit policies as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on the Prime rate. Commitments generally have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

4. Lease Assets held for Sale

The Company had a lease portfolio totaling \$7.0 million and \$8.7 million at December 31, 2008 and December 31, 2007, respectively. The lease portfolio is included as a component of total loans. Leases, like other types of loans, may become nonperforming at which time they are foreclosed upon and the remaining lease assets, including equipment and furniture, are transferred to lease assets held for sale which is included in other assets. Valuation adjustments, if required, at the time of foreclosure are charged to the allowance for loan losses. The Company discontinued making new leases during the first quarter of 2007, and since that time the balances in the lease portfolio have declined. The Company previously utilized a third-party broker to aid in the collection and ultimate disposition of lease assets held for sale. During the third quarter of 2007, the Company determined that the third-party broker no longer wished to continue collection and disposition efforts for the Company due to the Company's exit strategy from the leasing business. During the fourth quarter of 2007, the Company increased its efforts to dispose of existing lease assets held through foreclosure, while during the same period, additional lease assets were being foreclosed upon due to general declines in the economy. As a result, the Company reviewed the collectability of values recorded for lease assets held for sale during the fourth quarter of 2007 and charged-off \$820,000 of the lease assets held for sale. The expense is recorded as a component of noninterest expense for the year ended December 31, 2007. At December 31, 2008, the balance of lease assets held for sale was approximately \$6,000. The Company did not recognize any impairment on such assets during 2008.

5. Premises and Equipment

The components of premises and equipment are as follows:

(In thousands)	December 31,	
	2008	2007
Land	\$ 968	\$ 968
Buildings and improvements	14,212	14,160
Furniture and equipment	9,045	8,776
	24,225	23,904
Less accumulated depreciation and amortization	(9,940)	(8,330)
Total premises and equipment	\$ 14,285	\$ 15,574

During February 2007, the Company purchased Legacy Bank, N.A. in Campbell, California which included net fixed assets totaling \$729,000. Included in this amount were buildings and improvements of \$631,000, furniture and equipment of \$713,000, and accumulated depreciation of \$615,000. The Company determined that the net carrying value of Legacy fixed assets reasonably approximated fair value, and therefore did not make any additional fair value adjustments pursuant to purchase accounting guidelines.

Total depreciation expense on Company premises and equipment totaled \$1.7 million, \$1.6 million, and \$1.1 million for the years ended December 31, 2008, 2007 and 2006, respectively, and is included in occupancy expense in the accompanying consolidated statements of income.

6. Investment in Limited Partnership

The Bank owns limited interests in a private limited partnerships that acquire affordable housing properties in California that generate Low Income Housing Tax Credits under Section 42 of the Internal Revenue Code of 1986, as amended. The Bank's limited partnership investment is accounted for under the equity method. The Bank's noninterest expense associated with the utilization and expiration of these tax credits for the year ended December 31, 2008, 2007 and 2006 was \$432,000, \$430,000, and \$440,000, respectively. The limited partnership investments are expected to generate remaining tax credits of approximately \$2.6 million over the life of the investment. The tax credits expire between 2009 and 2014. Tax credits utilized for income tax purposes for the years ended December 31, 2008, 2007, and 2006 totaled \$519,000, \$545,000, and \$547,000, respectively.

7. Deposits

Deposits include the following:

(In thousands)	December 31,	
	2008	2007
Noninterest-bearing deposits	\$ 149,529	\$ 139,066
Interest-bearing deposits:		
NOW and money market accounts	136,612	153,717
Savings accounts	37,586	40,012
Time deposits:		
Under \$100,000	66,128	52,297
\$100,000 and over	118,631	249,525
Total interest-bearing deposits	358,957	495,551
Total deposits	\$ 508,486	\$ 634,617

At December 31, 2008, the scheduled maturities of all certificates of deposit and other time deposits are as follows:

(In thousands)	
One year or less	\$ 172,726
More than one year, but less than or equal to two years	9,037
More than two years, but less than or equal to three years	2,191
More than three years, but less than or equal to four years	144
More than four years, but less than or equal to five years	650
More than five years	11
	\$ 184,759

The Company may utilize brokered deposits as an additional source of funding. At December 31, 2008 and 2007, the Company held brokered time deposits totaling \$93.4 million and \$139.3 million, with average rates of 2.59% and 4.93%, respectively. Of this balance at December 31, 2008, \$68.9 million is included in time deposits of \$100,000 or more, and the remaining \$24.5 million is included in time deposits of less than \$100,000. Included in brokered time deposits at December 31, 2008 are balances totaling \$47.1 million maturing in three months or less, \$43.7 million maturing in three to six months, \$1.6 million maturing in 6 to twelve months, and \$850,000 maturing in more than one year.

Deposit balances representing overdrafts reclassified as loan balances totaled \$332,000 and \$565,000 as of December 31, 2008 and 2007, respectively.

Deposits of directors, officers and other related parties to the Bank totaled \$5.0 million and \$5.9 million at December 31, 2008 and 2007, respectively. The rates paid on these deposits were those customarily paid to the Bank's customers in the normal course of business.

8. Short-term Borrowings/Other Borrowings

At December 31, 2008, the Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$242.7 million, as well as Federal Home Loan Bank (“FHLB”) lines of credit totaling \$97.1 million. At December 31, 2008, the Company had total outstanding balances of \$155.0 million in borrowings, including \$66.5 million in federal funds purchased from the Federal Reserve Discount Window at an average rate of 0.50%, and \$88.5 million drawn against its FHLB lines of credit. Of the \$88.5 million in FHLB borrowings outstanding at December 31, 2008, \$77.5 million will mature in three months or less with an average rate of 1.1%, and the other \$11.0 million consists of a two-year FHLB advance at a fixed rate of 2.67%, and a maturity date of February 11, 2010. The weighted average cost of borrowings for the year ended December 31, 2008 was 2.32%. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company’s stock in the FHLB and certain qualifying mortgage loans. As of December 31, 2008, \$59.2 million in real estate-secured loans, \$55.8 million in investment securities, and \$16.4 million in interest-bearing deposits at FHLB, were pledged as collateral for FHLB advances. Additionally, \$268.3 million in real estate-secured loans were pledged at December 31, 2008 as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling \$211.2 million. All lines of credit are on an “as available” basis and can be revoked by the grantor at any time.

The Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$386.7 million, as well as Federal Home Loan Bank (“FHLB”) lines of credit totaling \$22.0 million at December 31, 2007. At December 31, 2007, the Company had total outstanding balances of \$32.3 million in borrowings, including \$10.4 million in federal funds purchased from correspondent banks at an average rate of 4.2%, and \$21.9 million drawn against its FHLB lines of credit.

9. Fair Value – Adoption of SFAS No. 159

Effective January 1, 2007, the Company elected early adoption of SFAS No.159, “The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115”. The Company also adopted the provisions of SFAS No. 157, “Fair Value Measurements”, effective January 1, 2007, in conjunction with the adoption of SFAS No. 159. SFAS No. 159 generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. Upon adoption of SFAS No. 159, the Company elected the fair value measurement option for all the Company’s pre-existing junior subordinated debentures with a carrying cost of \$15.5 million, prior to the adoption of SFAS No. 159.

The Company believes its adoption of SFAS No. 159 will have a positive impact on its ability to better manage the balance sheet and interest rate risks associated with this liability while potentially benefiting the net interest margin, net interest income, net income and earnings per common share in future periods. Specifically, the Company believes the election of fair value accounting for the junior subordinated debentures better reflects the true economic value of the debt instrument on the balance sheet, although valuations have become more subjective during 2008 and thus susceptible to significant changes as the result of relatively illiquid credit markets. The Company’s junior subordinated debentures were issued in 2001 when the Trust Preferred Securities market was new and less liquid than today. As a result, subordinated debentures are available in the market at narrower spreads and lower issuing costs. With a higher-than-market spread to LIBOR, and remaining capitalized issuance costs of more than \$400,000 on the balance sheet, the Company’s cost-basis of the subordinated debentures recorded on the balance sheet does not properly reflect the true opportunity costs to the Company.

The initial fair value measurement at adoption resulted in a \$1,053,000 cumulative-effect adjustment to the opening balance of retained earnings at January 1, 2007. The adjustment resulted in an increase of \$1,053,000 in the reported balance of the junior subordinated debentures, an increase in deferred tax assets of \$443,000 and the corresponding

reduction in retained earnings of \$610,000. Under SFAS No. 159, this one-time charge to shareholders' equity was not recognized in earnings. In addition to the fair value adjustment of the junior subordinated debentures recorded effective January 1, 2007, the Company also removed the remaining \$405,000 in unamortized issuance costs of the debt instrument. The remaining issuance costs were removed in accordance with SFAS 159 effective January 1, 2007, with corresponding charges of \$170,000 to deferred taxes and \$235,000 to retained earnings.

As a requirement of electing early adoption of SFAS 159, the Company also adopted SFAS 157, "Fair Value Measurement" effective January 1, 2007. The Company utilized the guidelines of SFAS No. 157 to perform the fair value analysis on the junior subordinated debentures. In its analysis, the Company used a net-present-value approach based upon observable market rates of interest, over a term that considers the most advantageous market for the liability, and the most reasonable behavior of market participants.

The following table summarizes the effects of the adoption of SFAS No. 159 at the adoption date, December 31, 2007, and December 31, 2008 (in 000's) on the Company's junior subordinated debentures. Changes in fair value (FV) for periods subsequent to adoption are recorded in current earnings. The pretax change in fair value for the years ended December 31, 2008 and December 31, 2007 totaled \$1.4 million and \$2.5 million, respectively, and is included as a gain in other noninterest income.

Balance of junior subordinated debentures at December 31, 2006	\$ 15,464
Adjustments upon adoption:	
Combine accrued interest 1/1/07	613
Total carrying value 1/1/07	16,077
FV adjustment upon adoption of SFAS No. 159	1,053
Total FV of junior subordinated debentures at adoption - January 1, 2007	\$ 17,130
Total FV of junior subordinated debentures at December 31, 2007	\$ 13,341
FV adjustment during 2008	(1,363)
Change in accrued interest during 2008	(52)
Total FV of junior subordinated debentures at December 31, 2008	\$ 11,926

10. Junior Subordinated Debt/Trust Preferred Securities

At June 30, 2007, the Company held junior subordinated debentures issued to capital trusts commonly known as "Trust Preferred securities." The debt instrument was issued by the Company's wholly-owned special purpose trust entity, USB Capital Trust I on July 25, 2001 in the amount of \$15,000,000 with a thirty-year maturity, interest benchmarked at the 6-month-LIBOR rate (re-priced in January and July each year) plus 3.75%. The Company had the ability to redeem the debentures at its option. The prepayment provisions of the instrument allowed repayment after five years (July 25, 2006) with certain prepayment penalties. On July 25, 2007, the Company redeemed the \$15.0 million in subordinated debentures plus accrued interest of \$690,000 and a 6.15% prepayment penalty totaling \$922,500. Concurrently, the Trust Preferred securities issued by Capital Trust I were redeemed. The prepayment penalty of \$922,500 had previously been a component of the fair value adjustment for the junior subordinated debt at the initial adoption of SFAS No. 159, and as a result was recorded through retained earnings effective January 1, 2007.

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred Securities. Like USB Capital Trust I formed in July 2001, USB Capital Trust II is a Variable Interest Entity (VIE) and will be considered a deconsolidated entity pursuant to FIN 46. On July 23, 2007 USB Capital Trust II issued \$15 million in Trust Preferred securities. The securities have a thirty-year maturity and bear a floating rate of interest (repricing quarterly) of 1.29% over the three-month LIBOR rate (initial coupon rate of 6.65%). Interest will be paid quarterly. Concurrent with the issuance of the Trust Preferred securities, USB Capital Trust II used the proceeds of the Trust Preferred securities offering to purchase a like amount of junior subordinated debentures of the Company. The Company will pay interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred securities. The Company may redeem the junior subordinated debentures at anytime before October 2008 at a redemption price of 103.3, and thereafter each October as follows: 2008 at 102.64, 2009 at 101.98, 2010 at 101.32, 2011 at 100.66, and at par anytime after October 2012.

As with the previous junior subordinated securities issued under USB Capital Trust I, the Company elected the fair value measurement option for all the Company's new junior subordinated debentures issued under USB Capital Trust II. During the year ended December 31, 2007, the Company recorded pre-tax gains of \$2.5 million pursuant to SFAS No. 159 as measured under fair value measurement guidelines of SFAS No. 157. The initial gain of \$2.1 million realized on USB Capital Trust II during the third quarter resulted from an overall deterioration of the credit markets during the third quarter of 2007 which increased pricing spreads from base rates on similar debt instruments. The Company recorded an additional gain on the junior subordinated debt of \$270,000 during the fourth quarter of 2007 bringing the year-to-date gain on the junior subordinated debt issued by USB Capital Trust II to \$2.4 million.

During each quarter for the year ended December 31, 2008 the Company performed a fair value measurement analysis on its junior subordinated debt pursuant to SFAS No. 157 using a valuation model approach that had been utilized in previous periods because of the absences of quoted market prices. Because the trust preferred markets became effectively inactive during the first quarter of 2008 due to increasing credit concerns in the capital markets, management used unobservable pricing spreads to 3-month LIBOR in the fair value determination of its junior subordinated debt. Management utilized a similar market spread from 3-month LIBOR to that used for the fourth quarter of 2007 when observable data were more available. Management believes this market spread remained indicative of those used by market participants throughout 2008, although for purposes of the fair value analysis performed for September 30, 2008 and December 31, 2008, that spread was increased by 20 basis points. The Company believes that when financial markets again normalize, market credit spreads will be slightly higher than they were prior to 2007, although it is difficult to determine by how much at this time.

The fair value calculation performed at December 31, 2008 resulted in a pretax gain adjustment of \$899,000 for the quarter ended December 31, 2008, and a cumulative pretax gain adjustment \$1.4 million for the year ended December 31, 2008. The cumulative gain adjustment made during the fourth quarter of 2008 is primarily the result of a 261 basis point decline in the 3-month LIBOR base rate between September 30, 2008 and December 31, 2008. At December 31, 2008, the total cumulative fair value gain recorded on the balance sheet for was \$3.7 million. Fair value gains and losses subsequent to initial adoption of SFAS No. 159 are reflected as a component of noninterest income.

11. Taxes on Income

The tax effects of significant items comprising the Company's net deferred tax assets (liabilities) are as follows:

(In thousands)	December 31,	
	2008	2007
Deferred tax assets:		
Credit losses not currently deductible	\$ 6,088	\$ 4,646
State franchise tax	355	525
Deferred compensation	1,430	1,249
Net operating losses	1,147	1,830
Startup/organizational costs	0	113
Depreciation	103	—
Accrued reserves	93	133
Write-down on other real estate owned	379	15
Capitalized OREO expenses	349	0
Unrealized gain on interest rate swap	0	39
Unrealized loss on AFS securities	1,954	44
Amortization of premium on time deposits	28	46
Other	76	95
Total deferred tax assets	12,002	8,735
Deferred tax liabilities:		
Depreciation	—	(24)
FHLB dividend	(243)	(204)
Loss on limited partnership investment	(1,814)	(1,590)
Amortization of core deposit intangible	(734)	(1,249)
Deferred gain SFAS No. 159 – fair value option	(1,538)	(998)
Fair value adjustments for purchase accounting	(120)	—
Prepaid expenses	(415)	(369)
Total deferred tax liabilities	(4,864)	(4,434)
Net deferred tax assets	\$ 7,138	\$ 4,301

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. The Company has concluded that it is more likely than not that the deferred tax assets will be recognized in the normal course of business, therefore no valuation allowance is considered necessary at December 31, 2008 and 2007.

Taxes on income for the years ended December 31, consist of the following:

(In thousands)	Federal	State	Total
2008:			

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Current	\$	1,461	\$	1,172	\$	2,633
Deferred		(400)		(628)		(1,028)
	\$	1,061	\$	544	\$	1,605
2007:						
Current	\$	3,640	\$	1,507	\$	5,147
Deferred		1,091		323		1,414
	\$	4,731	\$	1,830	\$	6,561
2006:						
Current	\$	6,284	\$	2,133	\$	8,417
Deferred		(390)		8		(382)
	\$	5,894	\$	2,141	\$	8,035

A reconciliation of the statutory federal income tax rate to the effective income tax rate is as follows:

	Years Ended December 31,		
	2008	2007	2006
Statutory federal income tax rate	34.0%	35.0%	35.0%
State franchise tax, net of federal income tax benefit	7.1	7.0	7.0
Tax exempt interest income	(0.4)	(0.2)	(0.2)
Low Income Housing – federal credits	(9.3)	(3.1)	(2.6)
Other	(3.1)	(1.9)	(1.4)
	28.3%	36.8%	37.8%

At December 31, 2008 the Company has remaining federal net operating loss carry-forwards totaling \$2.3 million which expire between 2023 and 2027, and remaining state net operating loss carry-forwards totaling \$5.3 million which expire between 2015 and 2019.

The Company adopted the provisions of FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes” (FIN48), on January 1, 2007. FIN 48 clarifies SFAS No. 109, “Accounting for Income Taxes,” to indicate a criterion that an individual tax position would have to meet for some or all of the income tax benefit to be recognized in a taxable entity’s financial statements. Under the guidelines of FIN48, an entity should recognize the financial statement benefit of a tax position if it determines that it is more likely than not that the position will be sustained on examination. The term, “more likely than not”, means a likelihood of more than 50 percent.” In assessing whether the more-likely-than-not criterion is met, the entity should assume that the tax position will be reviewed by the applicable taxing authority and all available information is known to the taxing authority.

The Company and a subsidiary file income tax returns in the U.S federal jurisdiction, and several states within the U.S. There are no filings in foreign jurisdictions. The Company is not currently aware of any tax jurisdictions where the Company or any subsidiary is subject examination by state or local taxing authorities before 2001, or by federal taxing authorities before 2005. The Internal Revenue Service (IRS) has not examined the Company’s or any subsidiaries federal tax returns since before 2001, and the Company currently is not aware of any examination planned or contemplated by the IRS. The California Franchise Tax Board (FTB) concluded an audit of the Company’s 2004 state tax return during the fourth quarter of 2007, resulting in a disallowance of approximately \$19,000 related to Enterprise Zone loan interest deductions taken during 2004. The \$19,000 was recorded as a component of tax expense for the year ended December 31, 2007.

During the second quarter of 2006, the FTB issued the Company a letter of proposed adjustments to, and assessments for, (as a result of examination of the tax years 2001 and 2002) certain tax benefits taken by the REIT during 2002. The Company continues to review the information available from the FTB and its financial advisors and believes that the Company's position has merit. The Company is pursuing its tax claims and will defend its use of these entities and transactions. The Company will continue to assert its administrative protest and appeal rights pending the outcome of litigation by another taxpayer presently in process on the REIT issue in the Los Angeles Superior Court (City National v. Franchise Tax Board).

The Company reviewed its REIT tax position as of January 1, 2007 (adoption date) and again during subsequent quarter during 2007 in light of the adoption of FIN48. The Bank, with guidance from advisors believes that the case has merit with regard to points of law, and that the tax law at the time allowed for the deduction of the consent dividend. However, the Bank, with the concurrence of advisors, cannot conclude that it is “more than likely” (as defined in FIN48) that the Bank will prevail in its case with the FTB. As a result of the implementation of FIN48, the Company recognized approximately a \$1.3 million increase in the liability for unrecognized tax benefits (included in

other liabilities), which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. The adjustment provided at adoption included penalties proposed by the FTB of \$181,000 and interest totaling \$210,000. During both the years ended December 31, 2008 and 2007, the Company recorded annually an additional \$87,000 in interest liability pursuant to the provisions of FIN48. The Company had approximately \$566,000 accrued for the payment of interest and penalties at December 31, 2008. Subsequent to the initial adoption of FIN48, it is the Company's policy to recognize interest expense related to unrecognized tax benefits, and penalties, as a component tax expense. A reconciliation of the beginning and ending amount of unrecognized tax benefits is as follows (in 000's):

Balance at January 1, 2008	\$ 1,385
Additions for tax provisions of prior years	87
Balance at December 31, 2008	\$ 1,472

12. Stock Options and Stock Based Compensation

Options have been granted to officers and key employees at an exercise price equal to estimated fair value at the date of grant as determined by the Board of Directors. All options granted are service awards, and as such are based solely upon fulfilling a requisite service period (the vesting period). In May 2005, the Company's shareholders approved the adoption of the United Security Bancshares 2005 Stock Option Plan (2005 Plan). At the same time, all previous plans, including the 1995 Plan, were terminated. The 2005 Plan provides for the granting of up to 500,000 shares (adjusted for the 2-for-1 stock split effective May 2006) of authorized and unissued shares of common stock at option prices per share which must not be less than 100% of the fair market value per share at the time each option is granted. The 2005 Plan further provides that the maximum aggregate number of shares that may be issued as incentive stock options under the 2005 Plan is 500,000 (as adjusted for stock split).

The options granted (incentive stock options for employees and non-qualified stock options for Directors) have an exercise price at the prevailing market price on the date of grant under the 1995 or 2005 Stock Option Plans. The options granted under both the 1995 and 2005 Stock Option Plans are exercisable 20% each year commencing one year after the date of grant and expire ten years after the date of grant. Pursuant to the adoption of the 2005 Stock Option Plan, there are no remaining shares reserved under the 1995 Stock Option Plan.

The number of shares granted remaining under the 1995 Plan was 16,322 shares (14,282 exercisable) as of December 31, 2008. Under the 2005 Plan, 159,646 shares granted shares remain (146,385 incentive stock options and 13,261 nonqualified stock options) as of December 31, 2008, of which 75,895 are vested.

Options outstanding, exercisable, exercised and forfeited are as follows:

	2005 Plan	Weighted Average Exercise Price	1995 Plan	Weighted Average Exercise Price
Options outstanding January 1, 2006	70,000	\$ 14.47	172,000	\$ 7.11
Granted during the year	103,500	\$ 18.91	—	—
Exercised during the year	(2,000)	\$ 12.65	(46,000)	\$ 6.73
Options outstanding December 31, 2006	171,500	\$ 17.05	126,000	\$ 7.25
Granted during the year	5,000	\$ 20.24	—	—
Exercised during the year	—	—	(90,000)	\$ 5.67
Options outstanding December 31, 2007	176,500	\$ 17.14	36,000	\$ 11.21
Granted during the year	—	—	—	—
Exercised during the year	—	—	(8,000)	\$ 8.75
Forfeited during the year	(20,000)	\$ 22.54	(12,000)	\$ 11.53
Effects of common stock dividend	3,145	\$ (0.31)	322	\$ (0.25)
Options outstanding December 31, 2008	159,645	\$ 16.13	16,322	\$ 11.96

Included in total outstanding options at December 31, 2008, are 14,282 exercisable shares under the 1995 plan, at a weighted average price of \$11.96, and 75,895 exercisable shares under the 2005 plan, at a weighted average price of \$15.72. Included in total outstanding options at December 31, 2007, are 24,000 exercisable shares under the 1995 plan, at a weighted average price of \$10.74, and 46,700 exercisable shares under the 2005 plan, at a weighted average price of \$16.34. Included in total outstanding options at December 31, 2006, are 108,000 exercisable shares under the

1995 plan, at a weighted average price of \$6.43, and 12,000 exercisable shares under the 2005 plan, at a weighted average price of \$14.44.

Additional information regarding options as of December 31, 2008 is as follows:

Range of Exercise Prices	Options Outstanding		Options Exercisable			
	Number Outstanding	Weighted Avg Remaining Contract Life (years)	Weighted Avg Exercise Price	Number Exercisable	Weighted Avg Exercise Price	
\$11.96 to \$12.40	24,482	6.3	\$ 12.11	18,362	\$ 12.06	
\$14.15 to \$17.74	120,372	6.8	\$ 15.41	60,390	\$ 18.61	
\$18.99 to \$22.09	31,113	7.4	\$ 19.89	11,425	\$ 19.90	
Total	175,967			90,177		

Included in salaries and employee benefits for the years ended December 31, 2008, 2007 and 2006 is \$110,000, \$187,000 and \$248,000 of share-based compensation, respectively. The related tax benefit on share-based compensation recorded in the provision for income taxes was not material to either year.

As of December 31, 2008, 2007 and 2006, there was \$81,000, \$223,500 and \$388,000, respectively, of total unrecognized compensation expense related to nonvested stock options. This cost is expected to be recognized over a weighted average period of approximately 1.0 years. The Company received \$70,000, \$510,000 and \$335,000 in cash proceeds on options exercised during the years ended December 31, 2008, 2007 and 2006, respectively. No tax benefits were realized on stock options exercised during the years ended December 31, 2008 and 2007, because all options exercised during the period were incentive stock options. Tax benefits realized on options exercised during the year ended December 31, 2006 totaled \$218,000.

	Year Ended December 31, 2008	Year Ended December 31, 2007
Weighted average grant-date fair value of stock options granted	n/a	\$ 4.51
Total fair value of stock options vested	\$ 173,393	\$ 167,028
Total intrinsic value of stock options exercised	\$ 55,000	\$ 1,517,000

The Bank determines fair value at grant date using the Black-Scholes-Merton pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock and the expected dividend yield and the risk-free interest rate over the expected life of the option.

The weighted average assumptions used in the pricing model are noted in the table below. The expected term of options granted is derived using the simplified method, which is based upon the average period between vesting term and expiration term of the options. The risk free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Expected volatility is based on the historical volatility of the Bank's stock over a period commensurate with the expected term of the options. The Company believes that historical volatility is indicative of expectations about its future volatility over the expected term of the options.

For options valued in accordance with FAS 123R, the Bank expenses the fair value of the option on a straight-line basis over the vesting period for each separately vesting portion of the award. The Bank estimates forfeitures and only recognizes expense for those shares expected to vest. Based upon historical evidence, the Company has determined that because options are granted to a limited number of key employees rather than a broad segment of the employee base, expected forfeitures, if any, are not material.

Year Ended
December 31, 2008 December 31, 2007

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Risk Free Interest Rate	—	4.53%
Expected Dividend Yield	—	2.47%
Expected Life in Years	—	6.50 Years
Expected Price Volatility	—	20.63%

The Black-Scholes-Merton option valuation model requires the input of highly subjective assumptions, including the expected life of the stock based award and stock price volatility. The assumptions listed above represent management's best estimates, but these estimates involve inherent uncertainties and the application of management judgment. As a result, if other assumptions had been used, the Bank's recorded stock-based compensation expense could have been materially different from that previously reported in proforma disclosures. In addition, the Bank is required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If the Bank's actual forfeiture rate is materially different from the estimate, the share-based compensation expense could be materially different.

13. Employee Benefit Plans

Employee Stock Ownership Plan

The Company has an Employee Stock Ownership Plan and Trust, (the "ESOP"), designed to enable eligible employees to acquire shares of common stock. ESOP eligibility is based upon length of service requirements. The Bank contributes cash to the ESOP in an amount determined at the discretion of the Board of Directors. The trustee of the ESOP uses such contribution to purchase shares of common stock currently outstanding, or to repay debt on the leveraged portion of the ESOP, if applicable. The shares of stock purchased by the trustee are then allocated to the accounts of the employees participating in the ESOP on the basis of total relative compensation. Employer contributions vest over a period of six years.

ESOP compensation expense totaled \$264,000, \$501,000, and \$409,000 for the years ended December 31, 2008, 2007, and 2006 respectively.

Allocated, committed-to-be-released, and unallocated ESOP shares as of December 31, 2008, 2007 and 2006 were as follows (shares adjusted for 2-for-1 stock split of May 2006):

	2008	2007	2006
Allocated	421,049	402,988	375,639
Committed-to-be-released	0	0	0
Unallocated	0	0	0
Total ESOP shares	421,049	402,988	375,639
Fair value of unreleased shares	N/A	N/A	N/A

401K Plan

The Company has a Cash or Deferred 401(k) Stock Ownership Plan (the "401(k) Plan") organized under Section 401(k) of the Code. All employees of the Company are initially eligible to participate in the 401(k) Plan upon the first day of the month after date of hire. Under the terms of the plan, the participants may elect to make contributions to the 401(k) Plan as determined by the Board of Directors. Participants are automatically vested 100% in all employee contributions. Participants may direct the investment of their contributions to the 401(k) Plan in any of several authorized investment vehicles. The Company contributes funds to the Plan up to 5% of the employees' eligible annual compensation. Company contributions are subject to certain vesting requirements over a period of six years. Contributions made by the Company are invested in Company stock. During 2008, 2007 and 2006, the Company contributed a total of \$137,000, \$286,000, and \$242,000, respectively, to the Deferral Plan.

Salary Continuation Plan

The Company has an unfunded, non-qualified Salary Continuation Plan for senior executive officers and certain other key officers of the Company, which provides additional compensation benefits upon retirement for a period of 15 years. Future compensation under the Plan is earned by the employees for services rendered through retirement and vests over a period of 12 to 15 years. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the Plan. The Company's current benefit liability is determined based upon vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for high-quality investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which averages approximately 20 years. At December 31, 2008 and 2007, \$3.3 million and \$3.0 million, respectively, had been accrued to date, based on a discounted cash flow using an average discount rate of 6.10% and 6.40%, respectively, and is included in other liabilities. In connection with the implementation of the Salary Continuation Plans, the Company purchased single premium universal life insurance policies on the life of each of the key employees covered under the Plan. The Company is the owner and beneficiary of these insurance policies. The cash surrender value of the policies was \$3.8 million and \$3.7 million December 31, 2008 and 2007, respectively. Although the Plan is unfunded, the Company intends to utilize the proceeds of such policies to settle the Plan obligations. Under Internal Revenue Service regulations, the life insurance policies are the property of the Company and are available to satisfy the Company's general creditors.

Effective December 31, 2006, the Company adopted Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans (“SFAS No. 158”). SFAS No. 158 amends SFAS No. 87 and SFAS No. 106, which the Bank previously has followed for accounting for its salary continuation plan.

SFAS No. 158 amends previous applicable accounting statements and requires companies to better disclose, among other things, the funded status of benefit plans, and to recognize as a component of other comprehensive income, net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost pursuant to FASB Statement No. 87, Employers’ Accounting for Pensions, or No. 106, Employers’ Accounting for Postretirement Benefits Other Than Pensions. Amounts recognized in accumulated other comprehensive income, including the gains or losses, prior service costs or credits, and the transition asset or obligation remaining from the initial application of Statements 87 and 106, are adjusted as they are subsequently recognized as components of net periodic benefit cost pursuant to the recognition and amortization provisions of those Statements.

In addition to expanded disclosure requirements under the Statement, the Company is required to recognize in accumulated other comprehensive income, the amounts that have not yet been recognized as components of net periodic benefit costs. These unrecognized costs arise from changes in estimated interest rates used in the calculation of net liabilities under the plan. Under SFAS No. 87 and SFAS No. 106, these differences were previously recognized over the remaining required service period of the salary continuation contracts. SFAS No. 158 requires the Company to record those unrecognized periodic benefit costs from previous period as a component of accumulated other comprehensive income.

As of December 31, 2008 and 2007, the Company had approximately \$13,000 in excess net periodic benefit costs and \$142,000 in unrecognized net periodic benefit costs, respectively, arising from changes in interest rates used in calculating the current post-retirement liability required under the plan. This amount represents the difference between the plan liabilities calculated under net present value calculations, and the net plan liabilities actually recorded on the Company’s books at December 31, 2008 and 2007. Pursuant to the adoption of SFAS No. 158, the Company recorded \$169,000 (net of tax of \$112,000), as a component of other comprehensive income at December 31, 2006. The average remaining life of the service terms of the Salary Continuation contracts to which the unrecognized service costs related at the time of adoption, was approximately two years. During the year ended December 31, 2008, approximately \$142,000 of the unrecognized prior service cost was recognized in earnings as additional salary expense, reflected as an adjustment to accumulated other comprehensive income.

Salary continuation expense is included in salaries and benefits expense, and totaled \$551,000, \$504,000, and \$448,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

Officer Supplemental Life Insurance Plan

During 2004, the Company purchased single premium Bank-owned life insurance policies (BOLI) on certain officers with a portion of the death benefits available to the officers’ beneficiaries. The single premium paid at policy commencement of the BOLI in 2004 totaled \$9.0 million. Additional BOLI policies totaling \$227,000 and \$579,000 were purchased during 2006 and 2005, respectively. The BOLI’s initial net cash surrender value is equivalent to the premium paid, and it adds income through non-taxable increases in its cash surrender value, net of the cost of insurance, plus any death benefits ultimately received by the Company. The cash surrender value of these insurance policies totaled \$10.6 million and \$10.2 million at December 31, 2008 and December 31, 2007, and is included on the consolidated balance sheet in cash surrender value of life insurance. Income on these policies, net of expense, totaled approximately \$249,000, \$408,000, and \$400,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

14. Commitments and Contingent Liabilities

Lease Commitments: The Company leases land and premises for its branch banking offices and administration facilities. The initial terms of these leases expire at various dates through 2019. Under the provisions of most of these leases, the Company has the option to extend the leases beyond their original terms at rental rates adjusted for changes reported in certain economic indices or as reflected by market conditions. The total expense on land and premises leased under operating leases was \$864,000, \$877,000, and \$407,000 during 2008, 2007, and 2006, respectively. Total rent expense for the years ended December 31, 2008 and 2007 included approximately \$27,000 and \$165,000, respectively, related to adjustments made under SFAS No. 13, "Accounting for Leases".

During the fourth quarter of 2007 the Company reviewed accounting methods for recording rent expense under operating leases pursuant to SFAS No. 13 "Accounting for Leases". The Company had previously recognized periodic rent expense as those contractual rent payments became payable to the lessor, rather than on a straight-line basis throughout the life of the lease. The difference in methodology was not previously considered material, but as the Company has grown, it was determined that adjustments should be made to properly comply with SFAS No. 13. The expense adjustment to record the difference between the contractual rental payment amounts and straight-line expense over the lease terms as applicable under SFAS No. 13 totaled \$165,000 (\$95,000 net of tax, and less than \$0.01 per share) and was recorded as a liability as of December 31, 2007. Adjustments made pursuant to SFAS No. 13 during 2008 increased the liability to \$191,000 at December 31, 2008. This timing difference will reverse beginning in 2009 and will decline over the remaining term of the Company's leases through 2019.

Future minimum rental commitments under existing non-cancelable leases as of December 31, 2008 are as follows:

(In thousands):	
2009	\$ 759
2010	713
2011	389
2012	392
2013	397
Thereafter	1,007
	\$ 3,657

Financial Instruments with Off-Balance Sheet Risk: The Company is party to financial instruments with off-balance sheet risk which arise in the normal course of business. These instruments may contain elements of credit risk, interest rate risk and liquidity risk, and include commitments to extend credit and standby letters of credit. The credit risk associated with these instruments is essentially the same as that involved in extending credit to customers and is represented by the contractual amount indicated in the table below:

	Contractual amount – December 31,	
(in thousands)	2008	2007
Commitments to extend credit	\$ 112,278	\$ 196,258
Standby letters of credit	7,119	6,726

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on the Prime rate, and most have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis, and the amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties. Many of the commitments are expected to expire without being drawn

upon and, as a result, the total commitment amounts do not necessarily represent future cash requirements of the Company.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company's letters of credit are short-term guarantees and have terms from less than one month to approximately 2.5 years. At December 31, 2008, the maximum potential amount of future undiscounted payments the Company could be required to make under outstanding standby letters of credit totaled \$7.1 million.

15. Fair Value Measurements and Disclosure

The following summary disclosures are made in accordance with the provisions of Statement of Financial Accounting Standards No. 107, "Disclosures About Fair Value of Financial Instruments," which requires the disclosure of fair value information about both on- and off- balance sheet financial instruments where it is practicable to estimate that value.

(In thousands)	December 31, 2008		December 31, 2007	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial Assets:				
Cash and cash equivalents	\$ 19,426	\$ 19,426	\$ 25,300	\$ 25,300
Interest-bearing deposits	20,431	20,490	2,909	2,918
Investment securities	92,749	92,749	89,415	89,415
Loans, net	548,742	539,540	596,481	594,054
Bank-owned life insurance	14,460	14,460	13,852	13,852
Investment in bank stock	121	121	372	372
Interest rate swap contracts	0	0	(12)	(12)
Financial Liabilities:				
Deposits	508,486	507,847	634,617	633,408
Borrowings	155,045	154,689	32,280	32,162
Junior Subordinated Debt	11,926	11,926	13,341	13,341
Commitments to extend credit	—	—	—	—
Standby letters of credit	—	—	—	—

Effective January 1, 2007, the Company adopted SFAS 157, "Fair Value Measurements", concurrent with its early adoption of SFAS No. 159. SFAS No. 157 clarifies the definition of fair value, describes methods generally used to appropriately measure fair value in accordance with generally accepted accounting principles and expands fair value disclosure requirements. Fair value is defined in SFAS No. 157 as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The statement applies whenever other accounting pronouncements require or permit fair value measurements.

The fair value hierarchy under SFAS No. 157 prioritizes the inputs to valuation techniques used to measure fair value into three broad levels (Level 1, Level 2, and Level 3). Level 1 inputs are unadjusted quoted prices in active markets (as defined) for identical assets or liabilities that the Company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability, and reflect the Company's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk) in a principal market.

The Company performs fair value measurements on certain assets and liabilities as the result of the application of accounting guidelines and pronouncements that were relevant prior to the adoption of SFAS No. 157. Some fair value measurements, such as for available-for-sale securities, junior subordinated debt, impaired loans that are collateral dependent, and interest rate swaps, are performed on a recurring basis, while others, such as impairment of goodwill and other intangibles, are performed on a nonrecurring basis.

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring basis during the year ended December 31, 2008 (in 000's):

Description of Assets	Quoted Prices in Active Mar- Significant Significant Un- kets for Identi-Other Observ- observable In- December 31, cal Assets able Inputs puts 2008 (Level 1) (Level 2) (Level 3)			
	AFS securities	\$ 92,749	\$ 13,017	\$ 66,932
Investment in bank stock	121	121		
Purchased intangible asset (1)	206			\$ 206
Impaired loans	22,452		4,602	\$ 17,850
Core deposit intangible (1)	1,283			\$ 1,283
Total	\$ 116,811	\$ 13,138	\$ 71,534	\$ 32,139
(1) Nonrecurring items				

Description of Liabilities	December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1) Other Observable Inputs (Level 2) Significant Unobservable Inputs (Level 3)		
		cal Assets (Level 1)	able Inputs (Level 2)	puts (Level 3)
Junior subordinated debt	\$ 11,926			\$ 11,926
Total	\$ 11,926	\$ 0	\$ 0	\$ 11,926

Upon adoption of SFAS No. 159 on January 1, 2007, the Company elected the fair value measurement option for all the Company's pre-existing junior subordinated debentures, and subsequently for new junior subordinated debentures issued during July 2007 under USB Capital Trust II. The fair value of the debentures was determined based upon discounted cash flows utilizing observable market rates and credit characteristics for similar instruments. In its analysis, the Company used characteristics that distinguish market participants generally use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. The adjustment for fair value at adoption was recorded as a cumulative-effect adjustment to the opening balance of retained earnings at January 1, 2007. Fair value adjustments subsequent to adoption were recorded in current earnings.

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring basis as of December 31, 2007 (in 000's):

Description of Assets	December 31, 2007	Quoted Prices in Active Markets for Identical Assets (Level 1) Other Observable Inputs (Level 2) Significant Unobservable Inputs (Level 3)		
		Assets (Level 1)	able Inputs (Level 2)	puts (Level 3)
AFS Securities	\$ 89,415	\$ 13,326	\$ 76,089	
Interest Rate Swap	(12)		\$ (12)	
Impaired Loans (non-recurring)	6,298		4,185	\$ 2,113
Total	\$ 95,701	\$ 13,326	\$ 80,262	\$ 2,113

Description of Liabilities	December 31, 2007	Quoted Prices in Active Markets for Identical Assets (Level 1) Other Observable Inputs (Level 2) Significant Unobservable Inputs (Level 3)		
		Assets (Level 1)	able Inputs (Level 2)	puts (Level 3)
Junior subordinated debt	\$ 13,341		\$ 13,341	
Total	\$ 13,341	\$ 0	\$ 13,341	\$ 0

The following tables summarize the Company's assets and liabilities that were measured at fair value on a nonrecurring basis during the year ended December 31, 2007 (in 000's):

Description of Assets	(in 000's) Dec 31, 2007	Quoted Prices in Active Mar- Significant Significant Un- kets for IdentifiOther Observ-observable In- cal Assets able Inputs puts (Level 1) (Level 2) (Level 3)		
		Business combination:		
Securities – AFS	\$ 7,414	\$ 7,414		
Loans, net allowance for losses	62,426			\$ 62,426
Premises and Equipment	729			729
Goodwill	8,790			8,790
Other assets	6,928			6,928
Total assets	\$ 86,287	\$ 7,414	\$ 0	\$ 78,873

Description of Liabilities	(in 000's) Dec 31, 2007	Quoted Prices in Active Mar- Significant Significant Un- kets for IdentifiOther Observ-observable In- cal Assets able Inputs puts (Level 1) (Level 2) (Level 3)		
		Business combination:		
Deposits (net CDI)	\$ 66,600			\$ 66,600
Other liabilities	286			286
Total liabilities	\$ 66,886	\$ 0	\$ 0	\$ 66,886

The Company completed its merger with Legacy Bank in February 2007. The merger transaction was accounted for using the purchase accounting method, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities. The allocations of purchase price based upon the fair value of assets acquired and liabilities assumed were finalized during the fourth quarter of 2007. The fair value measurements for Legacy's loan portfolio included certain market rate assumptions on segmented portions of the loan portfolio with similar credit characteristics, and credit risk assumptions specific to the individual loans within that portfolio. Available-for sale securities were valued based upon open-market quotes obtained from third-party sources. Legacy's deposits were valued based upon anticipated net present cash flows related to Legacy's deposit base, and resulted in a core deposit intangible (CDI) adjustment of \$3.0 million that is carried as an asset on the Company's balance sheet. Assumptions used to determine the CDI included anticipated costs of, and revenues generated by, those deposits, as well as the estimated life of the deposit base. Other assets and liabilities generally consist of short-term items including cash, overnight investments, and accrued interest receivable or payable, and as such, it was determined that carrying value approximated fair value.

The following tables provide a reconciliation of assets and liabilities at fair value using significant unobservable inputs (Level 3) on both a recurring (impaired loans) and nonrecurring (business combination) basis during the period (in 000's):

	12/31/08	12/31/08	12/31/08	12/31/07	12/31/07
	Impaired	CMO's	Intangi-	Impaired	Business
	loans		ble assets	loans	Combina-
					tions
Reconciliation of Assets:					

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Beginning balance	\$	2,211	\$	0	\$	0	\$	1,521	\$	0
Total gains or (losses) included in earnings (or changes in net assets)		(386)		(4,951)		(648)		(203)		9,910
Transfers in and/or out of Level 3		16,025		17,751		2,137		893		68,748
Ending balance	\$	17,850	\$	12,800	\$	1,489	\$	2,211	\$	78,658

The amount of total gains or (losses) for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	\$	(3,168)	\$	(4,951)	\$	(648)	\$	(203)	\$	9,910
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	12/31/2008	12/31/2007
	Junior Subordinated Debt	Business Combinations
Reconciliation of Liabilities:		
Beginning balance	\$ 0	\$ 0
Total gains included in earnings (or changes in net assets)	(1,363)	(3,215)
Transfers in and/or out of Level 3	13,289	69,600
Ending balance	\$ 11,926	\$ 66,385
The amount of total gains for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to liabilities still held at the reporting date	\$ (1,363)	\$ (3,215)

The following methods and assumptions were used in estimating the fair values of financial instruments:

Cash and Cash Equivalents - The carrying amounts reported in the balance sheets for cash and cash equivalents approximate their estimated fair values.

Interest-bearing Deposits – Interest bearing deposits in other banks consist of fixed-rate certificates of deposits. Accordingly, fair value has been estimated based upon interest rates currently being offered on deposits with similar characteristics and maturities.

Investments – Available for sale securities are valued based upon open-market price quotes obtained from reputable third-party brokers that actively make a market in those securities. Market pricing is based upon specific CUSIP identification for each individual security. To the extent there are observable prices in the market, the mid-point of the bid/ask price is used to determine fair value of individual securities. If that data is not available for the last 30 days, a level 2-type matrix pricing approach based on comparable securities in the market is utilized. Level-2 pricing may include using a spread forward from the last observable trade or may use a proxy bond like a TBA mortgage to come up with a price for the security being valued. Changes in fair market value are recorded in other comprehensive income as the securities are available for sale. At December 31, 2008, the Company held three private-label collateralized mortgage obligations (CMO's) with an amortized cost of \$17.6 million and carrying value of \$12.8 million. Fair value of these securities (as well as review for other-than-temporary impairment) was performed by a third-party securities broker specializing in CMO's. Fair value was based upon estimated cash flows which included assumptions about future prepayments, default rates, and the impact of credit risk on this type of investment security. Although the pricing of the CMO's has certain aspects of Level 2 pricing, many of the pricing inputs are based upon assumptions of future economic trends and as a result the Company considers this to be Level 3 pricing.

Loans - Fair values of variable rate loans, which reprice frequently and with no significant change in credit risk, are based on carrying values. Fair values for all other loans, except impaired loans, are estimated using discounted cash flows over their remaining maturities, using interest rates at which similar loans would currently be offered to borrowers with similar credit ratings and for the same remaining maturities.

Impaired Loans - Fair value measurements for impaired loans are performed pursuant to SFAS No. 114, and are based upon either collateral values supported by appraisals, or observed market prices. The change in fair value of impaired assets that were valued based upon level three inputs was approximately \$338,000 and \$690,000 for the years ended December 31, 2008 and 2007, respectively. This loss is not recorded directly as an adjustment to current earnings or comprehensive income, but rather as an adjustment component in determining the overall adequacy of the loan loss reserve. Such adjustments to the estimated fair value of impaired loans may result in increases or decreases to the

provision for credit losses recorded in current earnings.

98

Bank-owned Life Insurance – Fair values of life insurance policies owned by the Company approximate the insurance contract’s cash surrender value.

Investments in Bank Stock – Investment in Bank equity securities is classified as available for sale and is valued based upon open-market price quotes obtained from an active stock exchange. Changes in fair market value are recorded in other comprehensive income.

Interest Rate Swaps - The Company records interest rate swap contracts at fair value on the balance sheet. The fair value of interest rate swap contracts is based on the discounted net present value of the swap using third party dealer quotes.

Deposits – In accordance with SFAS No. 107, fair values for transaction and savings accounts are equal to the respective amounts payable on demand at December 31, 2008 and 2007 (i.e., carrying amounts). The Company believes that the fair value of these deposits is clearly greater than that prescribed by SFAS No. 107. Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

Borrowings - Borrowings consist of federal funds sold, securities sold under agreements to repurchase, and other short-term borrowings. Fair values of borrowings were estimated using the rates currently offered for borrowings with similar remaining maturities.

Junior Subordinated Debt – The fair value of the junior subordinated debt was determined based upon a valuation discounted cash flows model utilizing observable market rates and credit characteristics for similar instruments. In its analysis, the Company used characteristics that distinguish market participants generally use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. For the year ended December 31, 2008, management utilized a similar market spread from 3-month LIBOR to that used for the fourth quarter of 2007 when observable data were more available. The Company believes this adjustment is significant enough to the fair value determination of the junior subordinated debt as to make them Level 3 inputs as of March 31, 2008, June 30, 2008, September 30, 2008, and December 31, 2008. The junior subordinated debt was classified as Level 2 as of December 31, 2007.

Off-balance sheet Instruments - Off-balance sheet instruments consist of commitments to extend credit, standby letters of credit and derivative contracts. The contract amounts of commitments to extend credit and standby letters of credit are disclosed in Note 14. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties’ credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at December 31, 2008 and 2007.

Fair values of standby letters of credit are based on fees currently charged for similar agreements. The fair value of commitments generally approximates the fees received from the customer for issuing such commitments. These fees are deferred and recognized over the term of the commitment, and are not material to the Company’s consolidated balance sheet and results of operations.

16. Regulatory Matters

Capital Guidelines - The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements adopted by the Board of Governors of the Federal Reserve System (“Board of Governors”). Failure to meet minimum capital requirements can initiate certain mandates and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company’s consolidated financial

statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the consolidated Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require insured institutions to maintain a minimum leverage ratio of Tier 1 capital (the sum of common stockholders' equity, noncumulative perpetual preferred stock and minority interests in consolidated subsidiaries, minus intangible assets, identified losses and investments in certain subsidiaries, plus unrealized losses or minus unrealized gains on available for sale securities) to total assets. Institutions which have received the highest composite regulatory rating and which are not experiencing or anticipating significant growth are required to maintain a minimum leverage capital ratio of 3% of Tier 1 capital to total assets. All other institutions are required to maintain a minimum leverage capital ratio of at least 100 to 200 basis points above the 3% minimum requirement.

(In thousands)	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2008 (Company):						
Total Capital (to Risk Weighted Assets)	\$ 89,769	13.23%	\$ 54,293	8.00%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	81,225	11.97%	27,146	4.00%	N/A	N/A
Tier 1 Capital (to Average Assets)	81,225	10.58%	23,022	3.00%	N/A	N/A
As of December 31, 2008 (Bank):						
Total Capital (to Risk Weighted Assets)	\$ 86,161	12.61%	\$ 54,680	8.00%	\$ 68,351	10.00%
Tier 1 Capital (to Risk Weighted Assets)	78,234	11.45%	27,340	4.00%	41,010	6.00%
Tier 1 Capital (to Average Assets)	78,234	10.44%	22,479	3.00%	37,466	5.00%
As of December 31, 2007 - (Company):						
Total Capital (to Risk Weighted Assets)	\$ 89,136	12.18%	\$ 58,531	8.00%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	79,986	10.93%	29,265	4.00%	N/A	N/A
Tier 1 Capital (to Average Assets)	79,986	10.30%	23,299	3.00%	N/A	N/A
As of December 31, 2007 - (Bank):						
Total Capital (to Risk Weighted Assets)	\$ 86,294	11.79%	\$ 58,531	8.00%	\$ 73,164	10.00%
Tier 1 Capital (to Risk Weighted Assets)	77,144	10.54%	29,265	4.00%	43,898	6.00%
Tier 1 Capital (to Average Assets)	77,144	9.93%	23,299	3.00%	38,832	5.00%

The Board of Governors has also adopted a statement of policy, supplementing its leverage capital ratio requirements, which provides definitions of qualifying total capital (consisting of Tier 1 capital and supplementary capital, including the allowance for loan losses up to a maximum of 1.25% of risk-weighted assets) and sets forth minimum risk-based capital ratios of capital to risk-weighted assets. Insured institutions are required to maintain a ratio of qualifying total capital to risk weighted assets of 8%, at least one-half of which must be in the form of Tier 1 capital. Management believes, as of December 31, 2008, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2008 and 2007, the most recent notifications from the Bank's regulators categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the Bank must maintain minimum total capital and Tier 1 capital (as defined) to risk-based assets (as defined), and a minimum leverage ratio of Tier 1 capital to average assets (as defined) as set forth in the proceeding discussion. There are no conditions or events since the notification that management believes have changed the institution's category.

Under regulatory guidelines, the \$15 million in Trust Preferred Securities issued by USB Capital Trust II in July of 2008 qualifies as Tier 1 capital up to 25% of Tier 1 capital. Any additional portion of Trust Preferred Securities qualifies as Tier 2 capital.

Dividends - Dividends paid to shareholders are paid by the bank holding company, subject to restrictions set forth in the California General Corporation Law. The primary source of funds with which dividends will be paid to shareholders will come from cash dividends received by the Company from the Bank. Year-to-date as of December 31, 2008, the Company received \$4.3 million in cash dividends from the Bank, from which the Company has declared \$3.3 million in cash dividends to shareholders.

Under California state banking law, the Bank may not pay cash dividends in an amount which exceeds the lesser of the retained earnings of the Bank or the Bank's net income for the last three fiscal years (less the amount of distributions to shareholders during that period of time). If the above test is not met, cash dividends may only be paid with the prior approval of the California State Department of Financial Institutions, in an amount not exceeding the greater of: (i) the Bank's retained earnings; (ii) its net income for the last fiscal year; or (iii) its net income for the current fiscal year. During 2008, the Bank paid dividends of \$4.3 million to the Company. Because the distributions made by the Bank to the Holding Company over the past three fiscal years equal the amount of the Bank's net income for the last three years, at December 31, 2008, the Bank may not pay additional cash dividends without the prior approval of the California State Department of Financial Institutions.

Cash Restrictions - The Bank is required to maintain average reserve balances with the Federal Reserve Bank. During 2005, the Company implemented a deposit reclassification program, which allows the Company to reclassify a portion of transaction accounts to non-transaction accounts for reserve purposes. The deposit reclassification program was provided by a third-party vendor, and has been approved by the Federal Reserve Bank. At both December 31, 2008 and 2007, the Bank's qualifying balance with the Federal Reserve Bank was \$25,000 consisting of vault cash and balances.

17. Supplemental Cash Flow Disclosures

(In thousands)	Years Ended December 31,		
	2008	2007	2006
Cash paid during the period for:			
Interest	\$ 16,193	\$ 21,147	\$ 13,574
Income Taxes	2,219	6,411	8,287
Noncash investing activities:			
Loans transferred to foreclosed property	28,543	7,837	0
Dividends declared not paid	5	1,483	1,413
Supplemental disclosures related to acquisitions:			
Deposits	—	69,600	—
Other liabilities	—	286	—
Securities available for sale	—	(7,414)	—
Loans, net of allowance for loan loss	—	(62,426)	—
Premises and equipment	—	(728)	—
Intangibles	—	(11,085)	—
Accrued interest and other assets	—	(3,396)	—
Stock issued	—	21,536	—
Net cash and equivalents acquired	—	6,373	—

18. Common Stock Dividend

On December 16, 2008, the Company's Board of Directors declared a one-percent (1%) stock dividend on the Company's outstanding common stock. Based upon the number of outstanding common shares on the record date of January 1, 2009, an additional 118,449 shares were issued to shareholders on January 21, 2009. Because the stock

dividend was considered a “small stock dividend”, approximately \$1.4 million was transferred from retained earnings to common stock based upon the \$12.00 closing price of the Company’s common stock on the declaration date of December 16, 2008. Fractional shares were paid in cash, with a cash-in-lieu of payment of approximately \$5,000.

On September 23, 2008, the Company’s Board of Directors declared a one-percent (1%) stock dividend on the Company’s outstanding common stock. Based upon the number of outstanding common shares on the record date of October 10, 2008, an additional 117,732 shares were issued to shareholders on October 22, 2008. Because the stock dividend was considered a “small stock dividend”, approximately \$1.8 million was transferred from retained earnings to common stock based upon the \$15.65 closing price of the Company’s common stock on the declaration date of September 23, 2008. Fractional shares were paid in cash, with a cash-in-lieu of payment of approximately \$4,000.

Other than for earnings-per-share calculations, shares issued for the two stock dividends have been treated prospectively from December 31, 2008 for financial reporting purposes. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to the 1% stock dividends to shareholders for all periods presented.

19. Net Income Per Share

The following table provides a reconciliation of the numerator and the denominator of the basic EPS computation with the numerator and the denominator of the diluted EPS computation. (Weighted average shares have been adjusted to give retroactive recognition for 2-for-1 stock split during May 2006 and 1% stock dividend for each of the quarters ended September 30, 2008 and December 31, 2008):

(In thousands, except earnings per share data)	Years Ended December 31,		
	2008	2007	2006
Net income available to common shareholders	\$ 4,070	\$ 11,257	\$ 13,360
Weighted average shares outstanding	12,049	12,165	11,572
Add: dilutive effect of stock options	3	36	121
Weighted average shares outstanding adjusted for potential dilution	12,052	12,201	11,693
Basic earnings per share	\$ 0.34	\$ 0.93	\$ 1.15
Diluted earnings per share	\$ 0.34	\$ 0.92	\$ 1.14
Anti-dilutive shares excluded from earnings per share calculation	109	58	34

20. Other Comprehensive Income

The following table provides a reconciliation of the amounts included in comprehensive income:

(In thousands)	Years Ended December 31		
	2008	2007	2006
Unrealized (loss) gain on available-for-sale securities:			
Unrealized (loss) gain on sale securities – net of income tax (benefit) of (\$1,900), \$605, and \$253	(2,850)	\$ 909	\$ 379
Less: Reclassification adjustment for loss (gain) on sale of available-for-sale securities included in net income -net of income tax (benefit) of \$10, \$0, and \$11	(15)	0	(16)
Net unrealized (loss) gain on available-for-sale securities - net income tax (benefit) of (\$1,910), \$605, and \$242	\$ (2,865)	\$ 909	\$ 363
Unrealized loss on interest rate swaps:			
Unrealized losses arising during period – net of income tax benefit of \$1, \$110, and \$150	\$ (3)	\$ (165)	\$ (225)
Less: reclassification adjustments to interest income	5	310	493

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Net change in unrealized loss on interest rate swaps - net of income tax \$1, \$97, and \$140	\$	2	\$	145	\$	268
Previously unrecognized past service costs of employee benefit plans - net tax of \$62 and \$55	\$	93	\$	85		—
Total other comprehensive income (loss)	\$	(2,770)	\$	1,137	\$	631

21. Derivative Financial Instruments and Hedging Activities

As part of its overall risk management, the Company pursues various asset and liability management strategies, which may include obtaining derivative financial instruments to mitigate the impact of interest fluctuations on the Company's net interest margin. During the second quarter of 2003, the Company entered into an interest rate swap agreement with the purpose of minimizing interest rate fluctuations on its interest rate margin and equity.

Under the interest rate swap agreement, the Company received a fixed rate and pays a variable rate based on the Prime Rate ("Prime"). The swap qualified as a cash flow hedge under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities", as amended, and was designated as a hedge of the variability of cash flows the Company receives from certain variable-rate loans indexed to Prime. In accordance with SFAS No. 133, the swap agreement was measured at fair value and reported as an asset or liability on the consolidated balance sheet. The portion of the change in the fair value of the swap that was deemed effective in hedging the cash flows of the designated assets was recorded in accumulated other comprehensive income and reclassified into interest income when such cash flows occurred in the future. Any ineffectiveness resulting from the hedge was recorded as a gain or loss in the consolidated statement of income as part of noninterest income.

The amortizing hedge matured in September 2008. During the year ended December 31, 2008, \$5,000 was reclassified from other accumulated comprehensive income into expense, and is reflected as a reduction in interest income. The Company recorded pretax hedge gains related to swap ineffectiveness of approximately \$9,100 during the year ended December 31, 2008. Amounts recognized as hedge ineffectiveness gains or losses are reflected in noninterest income.

At December 31, 2007, the amortizing hedge had a remaining notional value of \$1.8 million and a duration of approximately three months. As of December 31, 2007, the net loss amounts in accumulated other comprehensive income associated with these cash flows totaled \$2,000. During the year ended December 31, 2007, \$310,000 was reclassified from accumulated other comprehensive income as a reduction to interest income. As of December 31, 2007, the amounts in accumulated OCI associated with these cash flows that were expected to be reclassified into interest income during the remainder of the hedge instrument in 2008 totaled \$9,000.

At December 31, 2008 and 2007, the information pertaining to the outstanding interest rate swap is as follows:

(000's in millions)	December 31, December 31,	
	2008	2007
Notional amount	—\$	1,753
Weighted average pay rate	—	8.05%
Weighted average receive rate	—	4.88%
Weighted average maturity in years	—	0.3
Unrealized loss relating to interest rate swaps	—\$	12

The Company performed a quarterly analysis of the effectiveness of the interest rate swap agreement at December 31, 2007 and for each of the quarters ended March 31, 2008 and June 30, 2008. As a result of a correlation analysis, the Company determined that the swap remained highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge and, therefore, continued to qualify for hedge accounting under the guidelines of SFAS No. 133. However, during the second quarter of 2006, the Company determined that the underlying loans being hedged were paying off faster than the notional value of the hedge instrument was amortizing. This difference between the notional value of the hedge and the underlying hedged assets is considered an "overhedge" pursuant to SFAS No. 133 guidelines and may constitute ineffectiveness if the difference is other than temporary. The Company determined during 2006 that the difference was other than temporary and, as a result, reclassified a net total of \$75,000 of the pretax hedge loss reported in other comprehensive income into earnings during 2006. As of

December 31, 2007, the notional value of the hedge was still in excess of the value of the underlying loans being hedged by approximately \$1.3 million, but had improved from the \$3.3 million difference existing at December 31, 2006. As a result, the Company recorded a pretax hedge gain related to swap ineffectiveness of approximately \$66,000 during the December 31, 2007. With the interest rate swap maturing on September 30, 2009, the Company recognized the remaining hedge ineffectiveness gains of \$9,000 during the nine months ended September 30, 2008. Amounts recognized as hedge ineffectiveness gains or losses are reflected in noninterest income.

22. Investment in Bank Stock

During December 2007, the Company purchased 33,854 common shares of Northern California Bancorp, Inc. (NRLB) in a privately negotiated transaction for a price of \$11.50 per share or approximately \$389,000. This purchase equals approximately 1.9% of NRLB's outstanding stock and will be treated as a marketable equity investment by the Company with changes in fair value recorded in earnings. NRLB is the holding company of Monterey County Bank. At December 31, 2007, the Company recorded a loss in its equity investment in NRLB of \$17,000 based on a quoted market price of \$11.00 per share at that date. The Company may purchase additional common shares of NRLB as shares become available.

During the first quarter of 2008, the Company more thoroughly reviewed its equity position in NRLB stock and determined that the stock should more properly be accounted for as available-for-sale-securities ("AFS") under the guidelines of SFAS No. 115. Management's decision was based upon the fact that these were clearly not trading securities. For this reason, the Company reclassified the NRLB stock holdings as available-for-sale securities effective January 1, 2008.

During the first quarter of 2008, the Company purchased an additional 6,517 shares at average price of \$11.00 per share bringing the total shares owned to 40,371 at a total carrying value of \$444,000. No further purchases we made during the remainder of 2008.

As with other debt and equity securities, the investment in NRLB stock is reviewed for other-than-temporary impairment under the guidelines of SFAS No. 115-1. Although the Company has recorded an unrealized AFS loss of \$323,000 (\$194,000 net of tax) through other comprehensive income at December 31, 2008 pursuant to SFAS No. 115, management has determined that the equity investment is not other-than-temporarily impaired at December 31, 2008. The AFS valuation was based upon a market price of \$3.00 per share for NRLB's stock at December 31, 2008. The Company believes this price is reflective of general market and economic conditions which have severely impacted financial stocks. The Company will continue to review its investment in NRLB stock on an ongoing basis as the economy recovers to determine whether the investment in NRLB stock is other-than-temporarily impaired.

23. Stock Split

On March 28, 2006, the Company's Board of Directors approved a 2-for-1 stock split of the Company's no par common stock effected in the form of a 100% stock dividend. The stock dividend was payable May 1, 2006 to shareholders of record as of April 7, 2006. Effective May 1, 2006, each shareholder received one additional share for each common share held as of the record date. All periods presented in the financial statements have been restated to reflect the effect of the 2-for-1 stock split.

24. Common Stock Repurchase Plan

During August 2001, the Company's Board of Directors approved a plan to repurchase, as conditions warrant, up to 280,000 shares (effectively 580,000 shares adjusted for 2-for-1 stock split in May 2006) of the Company's common stock on the open market or in privately negotiated transactions. The duration of the program is open-ended and the timing of the purchases will depend on market conditions.

On February 25, 2004, the Company announced another stock repurchase plan under which the Board of Directors approved a plan to repurchase, as conditions warrant, up to 276,500 shares (effectively 553,000 shares adjusted for 2-for-1 stock split in May 2006) of the Company's common stock on the open market or in privately negotiated transactions. As with the first plan, the duration of the new program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Board terminated the 2001

repurchase plan. During the year ended December 31, 2005, 13,081 shares (26,162 shares effected for 2006 2-for-1 stock split) were repurchased at a total cost of \$377,000 and an average price per share of \$28.92 (\$14.46 effected for 2006 2-for-1 stock split). During the year ended December 31, 2006, 108,005 shares were repurchased at a total cost of \$2.4 million and an average price per share of \$22.55.

On May 16, 2007, the Company announced a third stock repurchase plan to repurchase, as conditions warrant, up to 610,000 shares of the Company's common stock on the open market or in privately negotiated transactions. The repurchase plan represents approximately 5.00% of the Company's currently outstanding common stock. The duration of the program is open-ended and the timing of purchases will depend on market conditions. Concurrent with the approval of the new repurchase plan, the Company canceled the remaining 75,733 shares available under the 2004 repurchase plan.

During the year ended December 31, 2007, 512,332 shares were repurchased at a total cost of \$10.1 million and an average per share price of \$19.71. Of the shares repurchased during 2007, 166,660 shares were repurchased under the 2004 plan at an average cost of \$20.46 per shares, and 345,672 shares were repurchased under the 2007 plan at an average cost of \$19.35 per shares.

During the year ended December 31, 2008, 89,001 shares were repurchased at a total cost of \$1.2 million and an average per share price of \$13.70.

25.

Business Combination

On February 16, 2007, the Company acquired 100 percent of the outstanding common shares of Legacy Bank, N.A., located in Campbell, California. At merger, Legacy Bank's one branch was merged with and into United Security Bank, a wholly owned subsidiary of the Company. The purchase of Legacy Bank provided the Company with an opportunity to expand its market area into Santa Clara County and to serve a loyal and growing small business niche and individual client base build by Legacy.

The aggregate purchase price for Legacy was \$21.7 million, which included \$177,000 in direct acquisition costs related to the merger. At the date of merger, Legacy Bank had 1,674,373 shares of common stock outstanding. Based upon an exchange rate of approximately .58 shares of the Company's stock for each share of Legacy stock, Legacy shareholders received 976,411 shares of the Company's common stock, amounting to consideration of approximately \$12.86 per Legacy common share.

Legacy's results of the operations have been included in the Company's results beginning February 17, 2007.

During the second quarter of 2007, the Company re-evaluated the preliminary estimate of the core deposit intangible related to savings accounts acquired from Legacy and determined that the initial run-off of those deposits was faster than originally anticipated. As a result, the Company reduced the core deposits intangible by approximately \$215,000 from the amount reported at March 31, 2007. Correspondingly, resultant goodwill was increased by that same \$215,000. During the fourth quarter of 2007 recorded the final purchase accounting adjustments which reflected Legacy's final book-to-tax deferred tax amounts, and other deferred tax adjustments related to purchase accounting guidelines under SFAS No. 141. The result of adjustments made during the fourth quarter of 2007 was to increase the recorded NOL benefit by \$22,000, record deferred tax liabilities of \$727,000, and to increase goodwill by \$705,000.

The following summarizes the purchase and the resultant allocation to fair-market-value adjustments and goodwill:

Purchase Price:		
Total value of the Company's common stock exchanged	\$	21,536
Direct acquisition costs		177
Total purchase price		21,713
Allocation of Purchase Price:		
Legacy's shareholder equity		8,588
Estimated adjustments to reflect assets acquired and liabilities assumed at fair value:		
Investments		23
Loans		(118)
Deferred taxes		1,430
Core Deposit Intangible		3,000
Estimated fair value of net assets acquired		12,923
Goodwill resulting from acquisition	\$	8,790

The following condensed balance sheet summarizes the amount assigned for each major asset and liability category of Legacy at the merger date:

Assets:		
Cash	\$	3,173
Federal Funds Purchased		3,200

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Securities available for sale	7,414
Loans, net of allowance for loan losses	62,426
Premises and equipment	729
Deferred taxes	1,430
Core deposit intangibles	3,000
Goodwill	8,790
Accrued interest and other assets	1,437
Total Assets	\$ 91,599
Liabilities:	
Deposits:	
Non-interest bearing	\$ 17,262
Interest-bearing	52,338
Total deposits	\$ 69,600
Accrued interest payable and other liabilities	286
Total liabilities	\$ 69,886
Net assets assigned to purchase	\$ 21,713

The merger transaction was accounted for using the purchase accounting method, and resulted in the purchase price being allocated to the assets acquired and liabilities assumed from Legacy Bank based on the fair value of those assets and liabilities. The allocations of purchase price based upon the fair value of assets acquired and liabilities assumed were finalized during the fourth quarter of 2007. Management believes the Company will be able to fully utilize the net operating loss carry-forward (NOL) obtained in the Legacy merger. The Company has utilized a fair value approach for Legacy's loan portfolio which includes certain market rate assumptions on segmented portions of the loan portfolio with similar credit characteristics, and credit risk assumptions specific to the individual loans within that portfolio.

Core deposit intangibles with an original carrying value of \$3.0 million are being amortized for financial statement purposes over an estimated life of approximately 7 years using a method that approximates the interest method. Core deposit intangibles are reviewed for impairment on an annual basis. During the first quarter of 2008, the Company performed an impairment analysis of the core deposit intangibles associated with the Legacy Bank purchase. At that time it was determined that the core deposits were declining faster than originally anticipated. As a result, the Company recognized an impairment loss of \$624,000 for the quarter ended March 31, 2008 (see Note 26 below).

Goodwill totaling \$8.8 million is not being amortized for book purposes under current accounting guidelines. Because the merger was a tax-deferred stock-for-stock purchase, goodwill is not deductible for tax purposes. Goodwill will be reviewed for impairment on an annual basis. The Company has determined that there is no goodwill impairment as of December 31, 2008.

26. Impairment Loss – Core Deposit Intangible

The Company conducts periodic impairment analysis on its intangible assets and goodwill. Impairment analysis is performed at least annually or more often as conditions require.

During the first quarter of 2008, the Company performed an impairment analysis of the goodwill and core deposit intangible assets associated with the Legacy Bank merger completed during February 2007. The original goodwill and core deposit intangible assets recorded as a result of the Legacy merger totaled \$8.8 million and \$3.0 million respectively. Goodwill is not amortized. The core deposit intangible asset is being amortized over an estimated life of approximately seven years.

During the impairment analysis performed as of March 31, 2008, it was determined that the original deposits purchased from Legacy Bank during February 2007 had declined faster than originally anticipated when the core deposit intangible was calculated at the time of the merger. As a result of increased deposit runoff, particularly in interest-bearing and noninterest-bearing checking accounts, the estimated value of the Legacy core deposit intangible was determined to be \$1.6 million at March 31, 2008 rather than the pre-adjustment carrying value of \$2.3 million. As a result of the impairment analysis, the Company recorded a pre-tax impairment loss of \$624,000 (\$364,000 net of tax) reflected as a component of noninterest expense for the quarter ended March 31, and the year ended December 31, 2008. Pursuant to the impairment analysis conducted as of March 31, 2008, the Company determined that there was no impairment to the goodwill related to the Legacy merger. During the quarter ended December 31, 2008, the Company reviewed the Legacy core deposit intangible and goodwill, and determined that there was no additional impairment.

During the year ended December 31, 2008, the Company recorded \$523,000 of amortization expense related to the Legacy core deposit intangible asset bringing the net carrying value to \$1.3 million at December 31, 2008.

27. Parent Company Only Financial Statements

The following are the condensed financial statements of United Security Bancshares and should be read in conjunction with the consolidated financial statements:

United Security Bancshares – (parent only)

Balance Sheets - December 31, 2008 and 2007

(In thousands)	2008	2007
Assets		
Cash and equivalents	\$ 357	\$ 2,546
Investment in bank subsidiary	91,814	94,589
Investment in nonbank entity	99	122
Investment in bank stock	121	372
Other assets	476	470
Total assets	\$ 92,867	\$ 98,099
Liabilities & Shareholders' Equity		
Liabilities:		
Junior subordinated debt securities (at fair value) 12/31/07	\$ 11,926	\$ 13,341
Accrued interest payable	0	0
Deferred taxes	1,436	998
Other liabilities	(105)	1,329
Total liabilities	13,257	15,668
Shareholders' Equity:		
Common stock, no par value 20,000,000 shares authorized, 12,010,372 and 11,855,192 issued and outstanding, in 2008 and 2007	34,811	32,587
Retained earnings	47,722	49,997
Accumulated other comprehensive loss	(2,923)	(153)
Total shareholders' equity	79,610	82,431
Total liabilities and shareholders' equity	\$ 92,867	\$ 98,099

United Security Bancshares – (parent only)

Income Statements

(In thousands)	Years Ended December 31,		
	2008	2007	2006
Income			
Dividends from subsidiaries	\$ 4,250	\$ 17,600	\$ 7,300
Gain on fair value option of financial assets	1,363	2,504	0
Other income	10	0	0
Total income	5,623	20,104	7,300
Expense			
Interest expense	734	1,234	1,355
Other expense	401	469	378
Total expense	1,135	1,703	1,733
Income before taxes and equity in undistributed income of subsidiary	4,488	18,401	5,567
Income tax expense (benefit)	108	337	(729)

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(Deficit) equity in undistributed income of subsidiary	(310)	(6,807)	7,064
Net Income	\$ 4,070	\$ 11,257	\$ 13,360

107

United Security Bancshares – (parent only)
Statement of Cash Flows

(In thousands)	Years Ended December 31,		
	2008	2007	2006
Cash Flows From Operating Activities			
Net income	\$ 4,070	\$ 11,257	\$ 13,360
Adjustments to reconcile net earnings to cash provided by operating activities:			
Deficit (equity) in undistributed income of subsidiary	310	6,807	(7,064)
Deferred taxes	567	998	0
Write-down of other investments	23	17	0
Gain on fair value option of financial liability	(1,363)	(2,504)	0
Amortization of issuance costs	0	0	17
Net change in other liabilities	(15)	381	297
Net cash provided by operating activities	3,592	16,956	6,610
Cash Flows From Investing Activities			
Investment in bank stock	(72)	(389)	0
Proceeds from sale of investment in title company	0	0	149
Net cash (used in) provided by investing activities	(72)	(389)	149
Cash Flows From Financing Activities			
Proceeds from stock options exercised	70	510	335
Net proceeds from issuance of junior subordinated debt	0	(923)	0
Repurchase and retirement of common stock	(1,220)	(10,095)	(2,436)
Payment of dividends on common stock	(4,559)	(5,930)	(4,881)
Net cash used in financing activities	(5,709)	(16,438)	(6,982)
Net (decrease) increase in cash and cash equivalents	(2,189)	129	(223)
Cash and cash equivalents at beginning of year	2,546	2,417	2,640
Cash and cash equivalents at end of year	\$ 357	\$ 2,546	\$ 2,417
Supplemental cash flow disclosures			
Noncash financing activities:			
Dividends declared not paid	\$ 5	\$ 1,483	\$ 1,413

28. Quarterly Financial Data (unaudited)

Selected quarterly financial data for the years ended December 31, 2008 and 2007 are presented below:

(In thousands except per share data)	2008				2007			
	4th	3rd	2nd	1st	4th	3rd	2nd	1st
Interest income	\$ 10,036	\$ 10,936	\$ 11,431	\$ 12,744	\$ 14,245	\$ 14,713	\$ 13,962	\$ 14,236
Interest expense	2,967	3,509	3,702	4,759	5,450	5,494	5,126	4,503
Net interest income	7,069	7,427	7,729	7,985	8,795	9,219	8,836	9,733
Provision for credit losses	2,383	6,402	548	265	3,337	1,950	208	202
Gain (loss) on sale of securities	0	0	0	24	0	0	0	0
Other noninterest income	2,698	1,591	1,721	2,309	2,110	4,019	1,954	1,581

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Noninterest expense	6,254	5,265	5,644	6,116	6,723	5,292	5,517	5,200
Income before income tax expense	1,130	(2,649)	3,258	3,937	845	5,996	5,065	5,912
Income tax expense	289	(1,308)	1,188	1,437	156	2,339	1,757	2,309
Net income	\$ 841	\$ (1,341)	\$ 2,070	\$ 2,500	\$ 689	\$ 3,657	\$ 3,308	\$ 3,603
Net income per share:								
Basic	\$ 0.07	\$ (0.11)	\$ 0.17	\$ 0.21	\$ 0.06	\$ 0.31	\$ 0.27	\$ 0.30
Diluted	\$ 0.07	\$ (0.11)	\$ 0.17	\$ 0.21	\$ 0.06	\$ 0.31	\$ 0.27	\$ 0.30
Dividends declared per share	—	—	\$ 0.13	\$ 0.13	\$ 0.125	\$ 0.125	\$ 0.125	\$ 0.125
Average shares outstanding								
For net income per share:								
Basic	12,024	12,035	12,056	12,084	11,887	11,925	12,078	11,947
Diluted	12,024	12,041	12,059	12,094	11,900	11,946	12,135	12,006

108

Item 9 - Changes in and Disagreements with Accountants on Accounting and Financial Disclosure
None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures:

a) As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in the Securities and Exchange Act Rule 13(a)-15(e). Based upon that evaluation, the CEO and CFO concluded that, as of the end of the period covered in this report, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in reports that it files under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that material information relating to our consolidated operations is made known to the Company's management, including the CEO and CFO, particularly during the period when the Company's periodic reports are being prepared.

(b) Changes in Internal Controls over Financial Reporting:

At September 30, 2008, the Company determined that its disclosure controls and procedures were not effective as the result of an identified material weakness related to the allowance for loan and lease losses and the completeness and accuracy of the provision for loan and lease losses. Specifically the Company did not:

- Maintain sufficient policies and procedures to ensure that line personnel perform an analysis adequate to risk classify the current loan portfolio.
- Effectively have an adequate number of qualified and trained personnel in our credit administration to sufficiently identify problem loans timely.
- Maintain policies and procedures to ensure that SFAS 114 Accounting by Creditors for Impairment of a Loan documentation is prepared timely, accurately and subject to supervisory review.

During the fourth quarter of 2008, the Company undertook steps to remediate the material weakness identified at September 31, 2008. Given the significant increase in problem loan levels experienced during 2008, Management's objective was to improve staffing levels involved in the review process of the allowance for loan and lease losses, to ensure more timely and accurate identification and classification of problem and impaired loans, and to make sure that loss recognition, if required, was properly recorded on a timely basis.

Specific remediation steps taken during the fourth quarter of 2008 included:

- A thorough review of the Company's policies and procedures related to risk classifications of problem loans, SFAS 114, and the periodic review process to determine the adequacy of the allowance for loan and lease losses.
- Formation of a committee comprised of members of the Company's management and loan administration for the purpose of meeting on an ongoing basis to identify, classify, and properly provide an adequate level of allowance for loan and lease losses for the loan portfolio.
-

More in-depth review and verification of the allowance for loan and lease losses by the Accounting and Credit Administration departments to ensure its completeness and accuracy.

As of December 31, 2008, the Company concluded that the material weakness discussed above had been successfully remediated and that disclosure controls and procedures related to the allowance for loan and lease losses and the completeness and accuracy of the provision for loan lease losses were effective as of December 31, 2008.

Other than the material weakness discussed above, there were no additional changes in the Company's internal control over financial reporting that occurred during the fourth quarter of 2008 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

Management Report on Internal Control over Financial Reporting:

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of United Security Bancshares and Subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting, and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2008. The Company's internal control over financial reporting is a process designed under the supervision of the Company's management, including the Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

The Company's system of internal control over financial reporting includes policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Management recognizes that there are inherent limitations in the effectiveness of any system of internal control, and accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation and fair presentation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2008 based upon criteria in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, Management determined that the Company's internal control over financial reporting was effective as of December 31, 2008.

The Company's independent registered public accounting firm, Moss Adams LLP, who audits the Company's consolidated financial statements, have issued an attestation report on the effectiveness of the Company's internal control over financial reporting. This report is included in Item 8, "financial statements and supplementary data" to the Form 10-K.

Dated March 16, 2009

Item 9B. Other Information

None

PART III

Item 10 – Directors, Executive Officers, and Corporate Governance

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Election of Directors and Executive Officers" and "Corporate Governance Principles and Board Matters" set forth in the Company's definitive Proxy Statement for its 2009 Annual Meeting of Shareholders ("Proxy Statement").

Item 11 - Executive Compensation

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Executive Compensation" and "Director Compensation" set forth in the Company's definitive Proxy Statement for its 2009 Annual Meeting of Shareholders ("Proxy Statement").

Item 12 - Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled "Shareholdings of Certain Beneficial Owners and Management" set forth in the Company's definitive Proxy Statement for its 2009 Annual Meeting of Shareholders ("Proxy Statement").

Item 13 - Certain Relationships and Related Transactions, and Director Independence

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the captions entitled "Certain Transactions" and "Corporate Governance Principles" set forth in the Company's definitive Proxy Statement for its 2009 Annual Meeting of Shareholders ("Proxy Statement").

Item 14. Principal Accounting Fees and Services

Pursuant to Instruction G, the information required by this item is hereby incorporated herein by reference from the caption entitled "Independent Accountant Fees and Services" set forth in the Company's definitive Proxy Statement for its 2009 Annual Meeting of Shareholders ("Proxy Statement").

PART IV

Item 15 – Exhibits and Financial Statement Schedules

(a)(1) Financial Statements

The Consolidated Financial Statements and related documents set forth in “Item 8. Financial Statements and Supplementary Data” of this report are filed as part of this report.

(a)(2) Financial Statement Schedules

All financial statement schedules are omitted because they are not applicable or not required or because the information is included in the financial statements or notes thereto or is not material.

(a)(3) Exhibits

3.1 Articles of Incorporation of Registrant (1)

3.2 Bylaws of Registrant (1)

4.1 Specimen common stock certificate of United Security Bancshares (1)

10.1 Amended and Restated Executive Salary Continuation Agreement for Dennis Woods (4)

10.2 Amended and Restated Employment Agreement for Dennis R. Woods (4)

10.3 Amended and Restated Executive Salary Continuation Agreement for Kenneth Donahue (4)

10.4 Amended and Restated Change in Control Agreement for Kenneth Donahue (4)

10.5 Amended and Restated Executive Salary Continuation Agreement for David Eytcheson (4)

10.6 Amended and Restated Change in Control Agreement for David Eytcheson (4)

10.7 Amended and Restated Executive Salary Continuation Agreement for Rhodlee Braa (4)

10.8 Amended and Restated Change in Control Agreement for Rhodlee Braa (4)

10.9 Amended and Restated Executive Salary Continuation Agreement for William F. Scarborough (4)

10.10 Amended and Restated Change in Control Agreement for William F. Scarborough (4)

10.11 USB 2005 Stock Option Plan. Filed as Exhibit B to the Company's 2005 Schedule 14A Definitive Proxy filed April 18, 2005 and incorporated herein by reference.

10.12 Stock Option Agreement for William F. Scarborough dated August 1, 2005 (2)

10.13 Stock Option Agreement for Dennis R. Woods dated February 6, 2006 (3)

11.1 Computation of earnings per share.

See Note 19 to Consolidated Financial Statements and related documents set forth in “Item 8. Financial Statements and Supplementary Data” of this report are filed as part of this report.

21 Subsidiaries of the Company

112

23.1 Consent of Moss Adams LLP, Independent Registered Public Accounting Firm

31.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of the Chief Executive Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of the Chief Financial Officer of United Security Bancshares pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(1) Previously filed on April 4, 2001 as an exhibit to the Company's filing on Form S-4 (file number 333-58256).

(2) Previously filed on March 15, 2006 as an exhibit to the Company's filing on Form 10-K for the year ended December 31, 2006 (file number 000-32987).

(3) Previously filed on November 7, 2006 as an exhibit to the Company's filing on Form 10-Q/A for the period ended March 31, 2006 (file number 000-32987).

(4) Previously filed on March 17, 2007 as an exhibit to the Company's filing on Form 10-K for the year ended December 31, 2007 (file number 000-32987).

(b) Exhibits filed:

See Exhibit Index under Item 15(a)(3) above for the list of exhibits required to be filed by Item 601 of regulation S-K with this report.

(c) Financial statement schedules filed:

See Item 15(a)(2) above.

Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report on Form 10-K for the year ended December 31, 2008 to be signed on its behalf by the undersigned thereunto duly authorized, in Fresno, California, on the 16th day of March, 2009

United Security Bancshares

March 16, 2009 /S/ Dennis R. Woods
Dennis R. Woods
President and Chief Executive Officer

March 16, 2009 /S/ Kenneth L. Donahue
Kenneth L. Donahue
Senior Vice President and
Chief Financial Officer

March 16, 2009 /S/ Richard B. Shupe
Richard B. Shupe
Vice President and
Controller

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities on the date indicated:

Date:	3/16/2009	/s/ Robert G. Bitter Director
Date:	3/16/2009	/s/ Stanley J. Cavalla Director
Date:	3/16/2009	/s/ Tom Ellithorpe Director
Date:	3/16/2009	/s/ R. Todd Henry Director
Date:	3/16/2009	/s/ Ronnie D. Miller Director
Date:	3/16/2009	/s/ Robert M. Mochizuki Director
Date:	3/16/2009	/s/ Walter Reinhard Director
Date:	3/16/2009	/s/ John Terzian Director
Date:	3/16/2009	/s/ Mike Woolf Director